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CORPORATE GOVERNANCE IN ISLAMIC FINANCIAL INSTITUTIONS

by

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LIST OF ABBREVIATIONS

AAOIFI	:	Accounting & Auditing Organization for Islamic Financial Institutions
BCBS	:	Basel Committee on Banking Supervision
CEO	:	Chief Executive Officer
IDB	:	Islamic Development Bank
IFSB	:	Islamic Financial Services Board
IIFM	:	International Islamic Financial Market
IIRA	:	International Islamic Rating Agency
IMF	:	International Monetary Fund
IRTI	:	Islamic Research and Training Institute
LLR	:	Lender of Last Resort
LIBOR	:	London Inter-bank Offer Rate
LMC	:	Liquidity Management Centre
OECD	:	Organization for Economic Co-operation and Development
OIC	:	Organization of the Islamic Conference
PLS	:	Profit-and-Loss Sharing
VAR	:	Market risk and Value at Risk

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FOREWORD

The Islamic financial industry has been growing rapidly over the last three decades. This is a commendable achievement given the instability prevailing in the international financial market. One of the factors which has acted as a catalyst for this growth is the vast and growing volume of literature on the subject by a number of individuals as well as institutions. This has helped remove the mystery that hovered around interest-free Islamic finance and has made it become accepted as a viable and respectable way of financial intermediation.

IRTI has also played an important role in this development through its publications, lecture programmes and seminars in several Muslim as well as non-Muslim countries. In the earlier phase, IRTI produced a number of papers to clarify the concept of Islamic banking, its goals and modes of financing, and the way in which it could meet the short-, medium- and long-term financial needs of different sectors of an economy, including the public sector. This was, however, not all that our readers wanted to know about this nascent industry with a unique form of financial intermediation different from what the conventional banks were involved in. They also wanted to know the kind of regulation and supervision, risk management and corporate governance that the industry needed to be able to meet successfully the challenges it faced in a dynamic and complex international financial environment. Accordingly, the Board of Executive Directors of Islamic Development Bank, assigned to IRTI the task of preparing papers on these subjects. IRTI has responded by preparing a number of occasional papers on the subject. One of these was on the *Challenges Facing Islamic Banking* by Munwar Iqbal, Ausaf Ahmad and Tariqullah Khan; another was on *Regulation and Supervision of Islamic Banks* by M. Umer Chapra and Tariqullah Khan (2000); and a third was on: *Risk Management: An Analysis of Issues in Islamic Financial Industry,* by Tariqullah Khan and Habib Ahmed. The fourth paper, which is now in your hands, is on *Corporate Governance in Islamic Banks* by M. Umer Chapra and Habib Ahmed. In addition to analyzing the issues involved in the corporate governance of Islamic banks, it gives the results of a survey on the subject. This does not of course exhaust the task in a perennially changing economic and financial environment which brings new challenges as well as opportunities. IRTI will try its best to quench the thirst for a growing volume of literature on the subject to enable the

industry to face the challenges successfully and to benefit optimally from the opportunities available.

We will appreciate it if our readers, particularly regulators and bankers, will kindly indicate to us the issues on which further research is needed. This will help us respond more effectively to the needs of the industry. We wish to take this opportunity to express our grateful thanks to the Board of Executive Directors, the President, and Management of the Bank for the generous support that they have been continually providing to help us fulfil the need.

Mabid Ali al-Jarhi
Director, IRTI

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EXECUTIVE SUMMARY

The Islamic financial system, which had worked effectively for centuries during the heyday of the Muslim civilization, but which had become displaced by the conventional system after the colonization of most Muslim countries, has been having a resurgence over the last two to three decades. A number of Islamic financial institutions have been established around the world and several conventional banks have also opened Islamic windows. These have done fairly well so far and gained international acceptance. They need, nevertheless, to be strengthened further to enable them to continue their rapid expansion and enhance their international acceptance.

This brings into focus the measures that need to be taken to strengthen these institutions. One of these measures is the creation of an enabling environment. Some of the ingredients of such an environment are: proper market discipline in the financial sector, moral integrity on the part of financial institutions as well as users of funds, an appropriate socio-political environment along with the needed shared institutions, and effectively enforced legal and institutional checks. What is also indispensable is improved corporate governance, which has gained prominence over the last two decades even in the conventional financial system. It is, however, of even greater importance in the Islamic system because of the additional risk to which the depositors get exposed as a result of risk-sharing.

This takes the paper into a discussion of some of the most crucial aspects of corporate governance, including its objectives, mechanisms and tools. One of the most important objectives is resolution of the principal/agent conflict of interest with a view to promote the interests of all stakeholders as well as the soundness and stability of the financial system. The most important mechanisms for this purpose are the Board of Directors, Senior Management, shareholders and depositors. The paper discusses the measures that need to be taken to make the Board and the Management more effective and accountable in the performance of their roles and to enable the shareholders and depositors to play a greater role in protecting their own interests. The paper then addresses some of the standard tools that are available for making the Board and the Management more effective and accountable. These include proper internal controls, risk management, transparency,

loan accounting and disclosure, *Sharī'ah* clearance and audit, external audit, and regulation and supervision. It is necessary to apply all these effectively. This will, however, not help dispense with the need for a serious moral commitment on the part of all operators. Without such a commitment, it will be difficult to have self-enforcement. Market operators will try to find different ways of violating the law without getting detected and punished. This would necessitate a rise in legal checks and controls, the effective enforcement of which would raise transactions costs significantly. What is also needed is the establishment of a number of shared institutions to enable the Islamic system to operate effectively. If these institutions do not get established, even banks with the best corporate governance may not be able to avoid crises.

Since the effective performance of the mechanisms and tools of corporate governance as well as the establishment of shared institutions will take place gradually over a period of time, the Islamic financial system will evolve only gradually. This need for a gradual approach should not, however, be taken as a license for doing nothing to enable the system to expand and improve rapidly to be able to meet successfully the challenges that it faces.

To give a realistic touch to the study, an empirical Survey of regulators, financial institutions and depositors was conducted in the IDB member countries. The sample was, however, relatively small and it would, therefore, be desirable to be careful in drawing conclusions. Nevertheless, the Survey results give a fairly good idea of some major features of Islamic banks. They indicate that Islamic banks operate in an unfriendly environment and some of their difficulties are perhaps the result of this. Since these banks have not yet been able to make a significant headway towards the profit-and-loss sharing (PLS) mode of financing, the regulators do not see any significant difference in the risks involved in Islamic and conventional banking. This has become reflected in the regulatory and supervisory environment. Consequently, there is considerable room for regulatory reform to enable Islamic banking to meet successfully the challenges that lie ahead. The results also indicate that there is need for improvement in the composition of the Board of Directors as well as in Management, legal procedures and protection of the rights of stakeholders other than shareholders, particularly depositors. The Survey of depositors indicates that market discipline does play an important role in disciplining the Management of banks. This could, however, be further strengthened if, as a majority of depositors felt, they had representation on the Board .

1

INTRODUCTION

1.1 The Resurgence of Islamic Finance

A series of crises experienced by the international financial system over the last two decades have led to the call for a new architecture for the system. The primary feature of the new architecture that has received maximum emphasis so far at international forums, is improved corporate governance reinforced by prudential regulation and supervision. While these will certainly help in enhancing the soundness and stability of the financial system, they will not be sufficient. What is also needed is the injection of a built-in discipline in the financial system to ensure that the expansion of credit is not significantly out of proportion with the real economy and that the availability of credit for unproductive and speculative purposes is minimized. The Islamic financial system is oriented towards the injection of such discipline. It promotes relatively greater reliance on equity (*muḍārabah or mushārakah)* or the PLS *modes* of financing and a lesser reliance on debt. The debt is also required to be tied to the purchase and sale of real goods and services within the framework of the Islamic sales-based modes of financing (*murābahah, ijārah, salam* and *istiṣnā‘)* in which the financier also bears some risk to justify the reward that he gets.[1]

This system, which had thrived for centuries during the heyday of Muslim civilization but had become displaced by the conventional system after the colonization of most Muslim countries, is having a resurgence after their independence. A large number of Islamic banks have been established around the world over the last 25 years. In addition, a number of conventional banks have also established Islamic windows to attract the deposits of Muslims. These banks have been doing fairly well so far. Nevertheless, they are in their preliminary stage of evolution and, in spite of a rapid rate of growth, they have so far succeeded in gaining only a small niche in the financial sector of Muslim

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[1] For the definitions of these modes of financing, see the Glossary.

countries, not to speak of the much larger field of international finance. Moreover, they have so far placed a relatively much greater reliance on the debt-creating sales-based modes of financing and much less on the PLS modes, which constitute the real core of the Islamic financial system.

There is, thus, a great room for expansion and improvement to enable these banks to respond successfully to all the challenges that they face. One of the crucial needs for this purpose is continued confidence of the people in the system. Only if the banks are able to command the confidence of their clients will they be able to perform their central role of mobilizing deposits, promoting investment, expanding employment opportunities, helping the government finance its genuine development-related deficits, and accelerating economic development, which is one of the dire needs of the Muslim world at present.

This is because all financial systems have to take into account the stark reality that those who provide funds have expectations and that they will not do so if their expectations are not fulfilled. Depositors will not entrust their funds to banks until they are assured not only of the safety of their deposits but also of getting a satisfactory return or service and of being able to withdraw their deposits when they need them. Banks will also not lend these funds to users unless they are assured of repayment with a competitive rate of return. To ensure the fulfillment of these expectations as well as the soundness and stability of the financial system, improved corporate governance, which is now being emphasized in all international financial forums, will be of even greater importance in the Islamic financial system.

1.2 Factors that Contributed to the Success of the Islamic Financial System in the Past

This makes us go back in history to the heyday of Muslim civilization, to see the factors that made it possible for the ´/`*arrāfs* to fulfil the expectations of the people and to perform well, within the possibilities of the then-prevailing technological environment, most of

the functions that are now being performed by modern banks.[2] They evaluated the authenticity and fineness of coins, which was a very important function at that time when coins were made of precious metals. They put these coins in sealed bags of different sizes containing specified amounts of coins to relieve the people of the trouble of counting them every time they made or received a payment. They transferred funds from place to place without their physical transport and thereby ensured not only their safety but also the successful functioning of the payments system. They cashed checks and issued promissory notes and letters of credit. They also performed the crucial task of financial intermediation by mobilizing funds from savers and making them available to producers and traders primarily on the basis of *muḍārabah* and *mushārakah.*[3] They thereby financed agriculture, manufacturing and long-distance trade, and promoted economic development. They also helped each other overcome liquidity shortages on the basis a mutual-help arrangement which was then called *ibḍā‘* or *biḍā‘ah*.[4]

All the functions that the *´´‘arrāfs* performed demanded the total confidence of all the participants in each other. This raises the question of what enabled the *´´‘arrāfs* to command such confidence for centuries in the Muslim world and how can the Islamic banks do the same after their rebirth in modern times. The answer lies in the support that the system received from an enabling environment. Firstly, the market mechanism induced all participants in the market to do their jobs honestly and efficiently in their own long-run self-interest. This was further reinforced by Islamic values which were generally observed by the market participants. The then-prevailing religious environment helped create self-enforcement of these values.

Secondly, the *´´‘arrāfs* operated in communities which were far smaller compared with the communities in which modern banks

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2 See Dūrī*,* 1986, P.896; Kubaysī, 1979; ‘Ali, 1953; Sa‘dī, 1985 and Fischel, 1992; another, but less popular, name for *´´‘arrāfs* was *jahābidhah* (sigular, *jahbadh*).

3 See Dūrī, 1995, Pp.15-54 and Pp.192-200; and Ḥamdānī, 2000, Pp.22-33. See also Undovitch, 1970, Pp.170, 182 and 185. The sales-based modes of financing on which the Islamic banks rely heavily now were not in great use then.

4 See Chapra 1985, Pp.75 and 250.

operate. Accordingly, the depositors, the users of funds, and the *ṣarrāfs* were all well-known to each other. This created an environment of mutual confidence which insured the observance of Islamic values and reduced the probability of any one committing fraud and getting away with it unscathed.

Thirdly, this confidence of the different market operators in each other was further reinforced by an environment of mutual cooperation which existed between them because of their membership of tribes, guilds, fraternities and sufi orders. A number of them acted as merchants as well as agents at the same time, thereby increasing mutual dependence. Such dependence and cooperation created what Ibn Khaldun calls *'aṣabiyyah* or "social solidarity". This assured honesty and fairness in mutual dealings and, in turn, generated confidence in the system. Anyone who tried to cheat or procrastinate unduly became ostracized. The entire community would refrain from doing business with the guilty party. This acted as an informal contract enforcement mechanism and served as a deterrent against cheating and fraud. The climate of trust produced in this manner created a 'moral community' which broke geographical and linguistic barriers and facilitated flows of goods and financial capital. According to Udovitch, this system of mutual cooperation was not based on "a casual or occasional favour", but rather "a recognized commercial practice looming large in the discussion of partnership [*muḍārabah* and *mushārakah*] on the same level as deposit, pledge and similar contracts."[5]

Fourthly, the economic environment was also less complex and, in general, there seems to have been less volatility in economic variables, particularly prices and exchange rates, than what prevails in modern times.

Fifthly, the *ṣarrāfs* were individual proprietors or partnership firms and the separation of ownership and control was not a problem. The self-interest of the *ṣarrāfs* themselves as well as the users of funds reinforced mutual trust and confidence in the system that was supported by moral values and the cooperative spirit. *Muḍārabah* and

5 Udovitch, 1970, P.102. See also Grief, 1997; and Rauch, 2001.

Mushārakah were the primary methods for mobilizing financial resources and combining them with entrepreneurial and managerial skills for purposes of supporting crafts and manufacture and expanding long-distance trade. They brought to the disposal of commerce and industry the "entire reservoir of monetary resources of the medieval Islamic world" and served as a "means of financing, and to some extent, insuring commercial ventures, as well as providing the combination of skills and services for their satisfactory execution."[6]

Sixthly, the legal instruments necessary for the extensive use of financing through *muḍārabah* and *mushārakah* were also already available in the earliest Islamic period.[7] These instruments, which are found in a developed form in some of the earliest Islamic legal works,[8] were inspired by the Qur'ānic requirement that all loan transactions must be consummated in writing with witnesses (al-Qur'ān, 2.282). Written instruments thus became an important feature of financial intermediation.

Last, but not the least, what helped further was the strength and independence of the judicial system (*maḥkamah al-qaḍā'*). Courts ensured that contacts and agreements were abided by faithfully. It was also possible to get justice promptly at a low cost in terms of time, trouble and money. The office of the *qāḍī* (judge) "proved to be", according to Schacht, "one of the most rigorous institutions evolved by Islamic society." The *qāḍīs* (judges), along with the 'ulamā' (religious scholars), "played an important part in maintaining Islamic civilization, and in times of disorder they constituted an element of stability."[9]

Consequently, the costs of enforcing contracts were low and the system worked efficiently. This helped boost commerce, industry and agriculture, which thrived to an optimum level. Trade expanded from Morocco and Spain in the West, to India and China in the East, Central Asia in the North and Africa in the South. This is clearly indicated not only by available historical documents but also by the Muslim coins of the seventh to the eleventh centuries which have been found in several

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6 Udovitch, 1970, Pp.180 and 261.
7 Udovitch, 1970, P.77.
8 Udovitch, 1970, Pp.77-8.
9 Schacht, 1970, P.558

outlying parts of the then Muslim world including Russia, Finland, Sweden, Norway, the British Isles and Iceland.[10]

1.3 Can the System Operate Successfully in a Changed Environment?

This raises the question of whether the revival of the Islamic financial system can operate successfully in the modern world when the enabling environment prevailing in the Classical period does not exist fully any more. Banks operate in relatively larger communities where all the different stakeholders (shareholders, depositors, directors, management and users of funds) do not necessarily know each other very well. In a situation of anonymity that now prevails, depositors may hesitate to entrust their savings to banks, and banks may also be reluctant to provide financing to users on a PLS basis unless a climate of trust is created between the different operators in the financial market. The important question to be addressed, therefore, is about how to recreate such a climate of trust. Without effectively addressing this question the Islamic financial system may not be able to continue its expansion at the rapid rate necessary to create for itself a substantial niche in the financial system of Muslim countries. And even if it does so, it may be on the basis of continued greater reliance on the debt-creating sales-based modes of financing which may not enable the distinctive character of Islamic finance to come of age. It is necessary to create a new environment compatible with modern conditions to help minimize the risks and to create a climate of trust and confidence in all the participants in the Islamic financial market.

Risks are, however, not a peculiarity of only the Islamic financial system. They are rather present in all financial systems – risks associated with fiduciary money, interest rate and exchange rate fluctuations, loan default, operational failures, natural calamities, and a range of other human, managerial and environmental weaknesses. The Islamic financial system is equally exposed to all these risks. The only risk that gets added to the Islamic financial system is that which arises from the introduction of the PLS. Here also the Islamic financial system is not unique. Universal banking is also similar to a certain extent.

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10 Kramers, 1952, P.100; see also Pp.101-6.

Should the Islamic financial institutions accept this added risk? The answer has to be yes for two main reasons. Firstly, there is the moral imperative of avoiding the receipt and payment of interest. Believing Muslims have no choice. They have to submit before the Divine Will as expressed in the Qur'ān, which equates the indulgence in interest with the declaration of war against God and His Prophet, peace and blessings of God be on him (al-Qur'ān 2:279). Secondly, there is the satisfaction that the Divine Will is based on a strong rationale in terms of the help that it can give in the realization of humanitarian goals, one of the most important of which is justice (al-Qur'an, 57:25).[11] The interest-based system of financial intermediation is believed to have been responsible for aggravating not only inequities but also a number of other difficult economic problems - living beyond means, excessive expansion of credit, particularly short-term credit, high debt-servicing burden, volatility in the movement of funds as well as interest rates and exchange rates, and economic and financial uncertainties and instability. Although interest is not the only cause of these, it certainly has an important role to play in worsening them. Consequently, Mills and Presley have gone to the extent of saying: "There are sufficient grounds to wish that, in hindsight, the prohibition of usury had not been undermined in Europe in the sixteenth century. More practical wisdom was embodied in the moral stand against usury than was then realized."[12] The moral imperative as well as the strong economic rationale make it incumbent upon Muslims to implement the Islamic system in their economies.

The question, however, is whether it is possible to create an enabling environment in modern times to reward efficiency, honesty and fairness in the fulfillment of contracts and other obligations and to punish their violation. As already indicated, what helped the Classical environment to accomplish this was the prevalence of market discipline, along with moral values, social setup, and an efficient and impartial judicial system.

Most people would agree that both the market system and the judiciary exist even now and, if their functioning has become dented, it

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11 For a disucssion of this rationale, see Siddiqi, 1983; Chapra, 1985 and 2000; and Mills and Presley, 1999.

12 Mills and Presley, 1999, P.120.

should be possible to improve it. The adherence to moral values seems to have weakened. However, while proper upbringing is necessary for this, competitive markets along with better corporate governance and effective prudential regulation can help in ensuring the observance of even moral values.

The only thing that may, therefore, be said to be missing is the social setup - the smallness of communities to enable the market participants to know each other and the role of tribes, guilds, fraternities and sufi orders in complementing the role of judiciary in the fulfillment of contracts and the punishment of violations. It should be possible to ensure the effective performance of this function in modern times by making certain adjustments in the environment. Even the conventional financial system keeps on adapting itself to changing circumstances to be able to maintain the confidence of the stakeholders in the system. So why not the Islamic system?

A new environment can be created by adopting certain measures that would help minimize the risks and vulnerabilities of the financial system and raise the confidence in it of all stakeholders. To specify some of these important measures, IRTI has already published two occasional papers, one dealing with regulation and supervision of Islamic banks and the other with risk management.[13] The present paper, which is the third in the series, is concerned with improvement in corporate governance in Islamic banks. It indicates that the discipline that Islam wishes to introduce in the financial system would necessitate even greater stress on corporate governance. The two would together be able to lead to a sound and stable as well as justice- and growth-oriented financial system.

1.4 The Role of Effective Corporate Governance

Effective corporate governance in banks as well as the firms that use bank funds is one of the most important pillars of the new environment that needs to be created to replace the old socio-economic environment that no longer exists. Unfortunately, however, corporate governance is considered to be generally weak in the corporations of

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13 See Chapra and Khan, 2000; and Khan and Ahmed, 2001.

most developing countries.[14] This is because all the institutions that play a crucial role in disciplining markets and ensuring efficiency and integrity are not well-developed in these countries. Information asymmetries are more severe, market participants less experienced, and regulations, even if they exist, do not get enforced effectively and impartially because of political corruption and the general weakness of judicial systems. Disclosures are also not adequate and accounting practices are not well developed.[15] Consequently, these corporations suffer from inefficiencies and inequities that adversely affect all stakeholders. The adverse effects of ineffective corporate governance can be more serious in the case of financial institutions because the number of their stakeholders is much larger and the systemic risks are much greater.

There is no reason to assume that, even though the Islamic financial institutions have done fairly well so far, they have necessarily been able to escape the trappings of the prevailing weak corporate governance in developing countries. It should be possible to improve their performance considerably and to serve the interests of all stakeholders much better by making corporate governance more effective in these institutions.

Therefore, the strong rationale for greater reliance on equity in an Islamic economy intensifies the need for adoption of all those measures that would not only help improve the functioning of the financial system but also safeguard the interests of all stakeholders.[16] This paper is, however, not concerned with all these measures. It is primarily concerned with only one of these, and that is corporate governance, which is of concern to *all* financial systems. This is because banks in over 130 countries, comprising almost three-fourths of the member countries of the International Monetary Fund, have experienced serious problems over a period of less than two decades.[17] The chief features of these risks are well-known. They include runs on banks (sudden withdrawals of deposits), unexpected and rapid reversals by securities

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14 Schleifer and Vishny, 1997, P.738; Prowse, 1998, Pp.16-17.

15 See Prowse, 1998, P.16.

16 For some of these see, Iqbal, Khan and Ahmad, 1998; Chapra and Khan, 2000; Khan and Ahmed, 2001; and Al-Jarhi and Iqbal, 2001.

17 Lindgren, Garcia and Saal, 1996.

holders, excessive volatility in the foreign exchange market and generalized symptoms of panic among financial asset holders. Consequently, a great deal of literature has become available on corporate governance in conventional banks, particularly by the Basel Committee on Banking Supervision, and we have benefited from it considerably in the preparation of this paper.

Without effective corporate governance, it may not be possible to strengthen Islamic banks and to enable them to expand rapidly and perform their role effectively. This need will become more and more serious as the institutions expand and their problems become more complex – problems which will erode their ability in the long-run to meet successfully the challenges that they face. It is, therefore, not possible to avoid the taking of all those measures that would help improve the functioning of these institutions.

1.5 Objectives and Method of Research

One of the objectives of this paper is to discuss, and create greater awareness of, some of the crucial issues related to corporate governance in Islamic financial institutions. A second, but in fact more important, objective is to provide, in the light of this discussion, certain essential guidelines to improve corporate governance in these institutions and thereby enable them to not only maintain their momentum of growth and international acceptance but also safeguard the interests of all stakeholders. The paper gives particular attention to the mechanisms for corporate governance, including the Board of Directors, Senior Management, shareholders, depositors, and regulatory and supervisory authorities. It also focuses on the effective management of risks and, in particular, on creating a supporting environment through moral uplift, social, legal and institutional checks, greater transparency, internal controls, and *Sharī'ah* as well as *external* audit. The paper also indicates briefly the shared institutions that are needed for effective corporate governance.

To give a realistic touch to the discussion, the authors conducted an empirical study of corporate governance in Islamic banks. There have been a number of surveys of corporate governance in conventional banks conducted by different scholars.[18] Empirical studies of corporate governance in Islamic banks are relatively scarce and focus attention on specific issues. While some of these address the accounting and auditing aspects of corporate governance[19] others try to determine the overall strategies and investment policies as well as the role of *Sharī'ah* supervisory boards in the operation of these banks,[20] or compare the behaviour of Islamic banks' depositors with those of conventional banks.[21]

Compared with these, our Survey is more comprehensive. It was undertaken with the objective of identifying the environment within which Islamic financial institutions operate and the overall state of their corporate governance. Even though this objective was ambitious, it was considered necessary for improving the future strength and expansion of these institutions. The banks included in our Survey are relatively small with average capital and assets of US$ 744 and $ 412.2 million respectively. (Table 2.2 of Part I of Appendix 1).[22] This is, however, not unique to those in our sample. All Islamic banks are relatively small compared with conventional banks. Their average capital and assets were $ 417 million and $839.1 million in 1997, the last year for which data are available.[23] The Survey results give a fairly good idea of some major features of corporate

[18] ` See Part I of Appendix I for the nature of some of these surveys.
[19] See, for example, Gambling and Karim, 1991; Karim, 1990; Archer and Abid, 1996; Baydoun and Willet, 1997; Banaga, et. al., 1994; Hood and Bucheery, 1999.
[20] Lewis and Algaoud, 2001.
[21] Erol, et. al., 990.
[22] All Tables referred to in the text refer to those in Part I of Appendix I unless specified otherwise.
[23] International Assocaiton of Islamic Banks, 1997.

governance in Islamic banks. Nevertheless, it would be desirable to be cautious in drawing conclusions because of the small size of the sample.

The Survey is based on questionnaires sent by mail to 30 countries along with field level interviews in three countries: Bangladesh, Bahrain, and Sudan. It was conduced at three levels. At the regulators' level, the information came mainly from the responses to our questionnaires sent to central banks by mail (Tables 1.1 – 1.6). At the level of financial institutions, the information was gathered by using two methods. These were: firstly, interviews with the management of banks in Bahrain, Bangladesh, and Sudan; and secondly, responses to questionnaires sent to financial institutions in other countries (Tables 2.1 – 2.16). At the level of depositors the information was obtained through the completion of questionnaires by means of interviews of depositors of Islamic banks in the three countries mentioned above (Tables 3.1 – 3.10).

2

CORPORATE GOVERNANCE: BASIC CONCEPTS AND ISSUES

2.1 Why Corporate Governance?

The term 'corporate governance' has gained prominence only during the last two decades[24] and all its ramifications have not yet become fully spelled out even though a substantial volume of literature has become available on the subject. It has been defined in different ways depending upon the author's centre of concern. The Organisation for Economic Co-operation and Development (OECD) has defined it as the "set of relationships between a company's management, its board, its shareholders and other stakeholders."[25] This is a value neutral definition in the normal tradition of Economics and does not indicate the objective of corporate governance, which is bound to be value oriented. However, Mr. Wolfensohn, World Bank President, has gone a step further and indicated the purpose behind corporate governance to be "fairness, transparency and accountability." [26] This definition makes it clear that the objective is to ensure "fairness" to all stakeholders to be attained through greater transparency and accountability. Fairness may also be taken to imply, in the case of shareholders, a 'fair' growth in the value of their equity. Several other definitions of corporate governance are available but it would not be of great benefit to reproduce them here. [27]

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[24] Zingales, 1997, P.1.

[25] OECD, April 1999, P.2.

[26] Financial Times, 21 June 1999, cited by the Encyclopaedia of Corporate Governance in the article on "What is Corporate Governance" (www.encycogov.com), 11 July 2001, P.1.

[27] Some other definitions of corporate governance are:

- "Corporate governance is broadly the complex set of socially-defined constraints that affect the willingness to make investments in corporations in exchange for promises" (Dyck, 2000, P.7)
- "Corporate governance is, to a large extent, a set of mechanisms through which outside investors protect themselves against expropriation by the insiders." (La Porta, Lopez-de-Salines, Shleifer and Vishny (1999, cited from a Harvard manuscript by Dyck, 2000, P.7).

There are a number of players and stakeholders in Islamic financial institutions (see Table 1 and Figure 1, both in the text). This raises the issue of whether it is necessary to safeguard the interests of all stakeholders. The Western academia are divided into two groups in their discussion of this subject. One of these, the Anglo-American model of corporate governance, focuses exclusively on the maximization of shareholder value. According to this model, if the objective of maximizing shareholder value conflicts with the interests of other stakeholders, those other interests should be ignored.[28] The Franco-German model, by contrast, places the same amount of emphasis, at least in theory, on protecting the interests of other stakeholders. There is, however, doubt whether corporate governance in the US is in practice as closely aligned with the interest of shareholders as it appears to be in theory and whether the Franco-German model actually protects the interests of non-shareholder constituencies as much as it is claimed.[29]

This controversy takes us to the question of whether there can be any doubt within the Islamic value system about equitably protecting the rights of all stakeholders, irrespective of whether they hold equity or not. In a value system which gives maximum priority to the realization of justice and fairness, there can be no question about protecting the interests of all in an equitable manner. The results of our Survey do not, however, indicate that Islamic banks have been able to do this so far. This may perhaps be because the importance of this has not been fully realized and also because the task is undoubtedly difficult. Nevertheless, a sincere and well-conceived effort needs to be made.

The most important stakeholder in the case of Islamic finance is Islam itself. If the banks do not perform well, those who assume the Islamic system to be out of tune with the modern world may try to blame Islam for the poor performance of these banks even though Islam may itself have nothing to do with it. Shareholders' stake is unquestionably recognized. However depositors, whose interest is also at stake, do not generally get much attention in the normal Anglo-American as well as

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- "Corporate governance is the complex set of constraints that shape the ex-post bargaining over the quasi-rents generated by the firm." (Zingales, 1997, P.4)

28 Macey and O'hara, forthcoming, Pp.1 and 5.

29 *Ibid.* P.2.

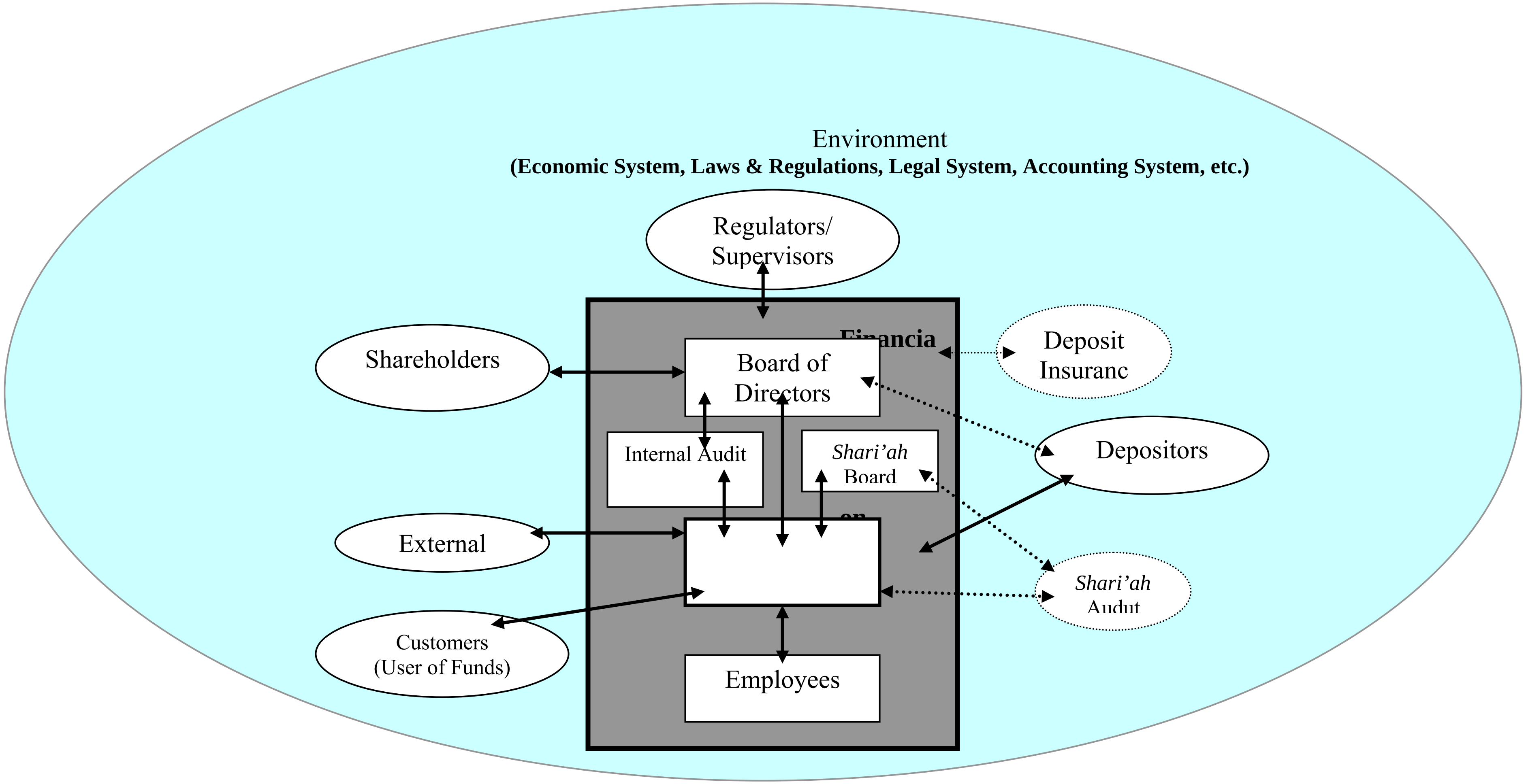
Franco-German discussions of corporate governance in conventional banks. This is because all deposits are insured and the rate of return is known in advance. Since

Table 1
Key Players in Corporate Governance (CG) of Islamic Financial Institutions (IFIs)

	Important Issues	**Objectives/ Responsibilities in CG**
Environment		
Overall Economic, Financial, and Legal System	Efficiency in the legal system Enforceability of contracts Rule of law	Promote strong business and legal environments that support CG
Government (Laws and Regulations for IFIs)	Laws facilitating operations of Islamic financial institutions	Provide clear laws and regulations that cater to the needs of IFIs.
Accounting System	Accounting and Audit standards for clear and transparent communication of information	Provide uniform, clear and transparent accounting standards
Public Institutions		
Supervisors	Stability and soundness of the financial system (eliminate systemic risk) Develop internal controls, risk management procedures, and standards of transparency	Provide Guidelines for FIs Monitor overall operations in general and risky behavior in particular
Banking Associations	Provide minimum standards of CG	Set Principles and Sound practices
Institutional		
Shareholders	Shareholder Rights	Elect board members

	Share in profit	
Board of Directors	Ensure good management team Oversight of management Protect shareholders and investment depositors rights	Set overall policy and strategy Accountability of the management
Senior Management	Operate the institution efficiently. Right balance between risk and return Efficient incentive-structure	Implement the policies set by the board in a sound and responsible manner
Internal Audit	Quality and quantity of information Transparency of information	Ensure that the policies set by Board are followed by the management (Compliance)
Employees	Skills and work ethics Right incentive-structure	Meet the goals set by the management Minimize operational risks
Sharīʻah Boards	Set *Sharīʻah* related rules and principles	Oversee compliance with its verdict
Others		
Depositors	Good service Comparable returns	Act responsibly Monitor the performance
External Auditors	Quality and quantity of information Transparency of information	Evaluate the accuracy of the quality and quantity of information
Sharīʻah Audit	Adherence to the *Sharīʻah*	Ensure compliance with the *Sharīʻah* Board verdicts.

Figure 1: Key Players in Corporate Governance of Islamic Financial Institutions



Indicates the link exists

Indicates the link does not exist or

investment depositors share in the profit and loss in the Islamic system, their interest needs to be protected. Demand depositors, even though their deposits are guaranteed, have their interest at stake because of the fear that the losses suffered by investment depositors may inadvertently get shifted to demand depositors unless firewalls are constructed between the operations based on these two sets of deposits. Employees also have a stake. Their contribution to the efficient performance of the bank and their remuneration are both determined by the bank's incentive structure. The better the bank performs, the better are their emoluments and the greater the incentive effect. The financial system is at stake because the failure of major banks can create a crisis and hurt the whole economy. The interest of governments is also at stake because the effective performance of banks can benefit them in a number of ways. This will induce them to ensure that regulatory and supervisory authorities perform their tasks conscientiously in the public interest. Thus, in short, the economy and the society are as a whole at stake because the ineffective functioning of the financial system can exert an adverse effect on all sectors of the economy and society through financial instability as well as lower rates of economic growth and general well-being.[30]

The objective of satisfying the conflicting interests of all stakeholders brings into focus the crucial role of corporate governance. The crux of this role is to create a 'fair' equilibrium among the different stakeholders through a broad range of formal as well as informal rules, standards and constraints aimed at directing and controlling the bank in a way that would safeguard the interests of all at a relatively low cost. The cost is an important consideration because, if the cost is high, there will be an excuse for not safeguarding the interests of all stakeholders. In this case the stakeholders who are weak will be hurt, and the equilibrium may not then be stable. There will be discontent and unrest, which will become reflected in the lack of confidence of stakeholders in

[30] According to the BCBS, 'stakeholders' include 'employees, customers, suppliers and the community. Due to the unique role of banks in national and local economies and financial systems, supervisors and governments are also stakeholders.: (BCBS, September 1999, P.3, footonote 3.)

the fairness of the system and lead to an unsatisfactory growth of the financial sector as well as the economy.

This leads us to the problem that, while in a conventional corporation or bank the primary conflict of interest is generally considered to be between the shareholders and the management, in an Islamic bank another important dimension gets injected and that is of depositors. It is the depositors rather than the shareholders who provide a preponderantly large proportion of funds. Management may not have a direct interest in enhancing the utility of either the shareholders or the depositors, particularly because those in charge of management may not have contributed any capital or deposits of their own to the bank's resources. This may induce them to take undue risks, and also keep unjustifiably high gains for themselves through salaries, perks and other means. They may, therefore, be unable not only to give a competitive rate of return to depositors but may also make the bank more vulnerable to shocks. Demand depositors may suffer even more because, as indicated earlier, even without getting any return they may get indirectly exposed to risks if their deposits are used for risky investments, and the resulting losses reduce the bank's ability to honour the withdrawal of these deposits

One may argue within the framework of the evolutionary theory of economic change that there is no reason to worry about the conflict of interests because market forces will themselves resolve the conflict. Competition will in the long run establish an equilibrium which will satisfy the interests of all stakeholders in an optimum manner.[31] Experience has, however, shown that sole dependence on the role of market forces in ensuring effective corporate governance is not realistic.[32] One of the basic reasons for this assertion is that nobody has the patience to wait for the long-run because, as Keynes has rightly observed, "in the long-run we may all be dead."[33] Another reason is that investments in firms by suppliers of finance are not exchanged simultaneously with something tangible. There is only a promise of unspecified future returns and investors need to have confidence in the honest fulfillment of this promise.

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31 Alchian, 1950.
32 Schleifer, and Vishny, 1997, P.738.
33 Keynes, 1924 in *Colleted Writings*, 1972, P.85.

It is, therefore, necessary to promote promise fulfillment. This will foster availability of resources to banks as well as firms. Studies on corporate governance indicate that both the explicit and implicit terms of such promises tend to be routinely violated by the 'grabbing hands' of insiders.[34] These studies provide evidence and insights and point to a number of ways of protecting stakeholders. Some of these ways are: market mechanism, social values and environment, effective regulation and supervision, integrity and efficiency of the judiciary, enabling ownership structure, and a political authority motivated to perform its functions effectively.[35] The studies also reveal a surprising lack of investor protections and of dispersion of approaches to protections when one looks around the world.[36]

2.2 Principal /Agent Problem

This brings us to the crucial question of why there is violation of promise fulfillment. The primary reason is the separation of management and finance or of ownership and control, which gives rise to the principal/agent problem. While this is true in the case of all corporations, it is more complex in the case of banks because of their much larger leverage and the associated systemic risk.[37]

The principal agent problem also exists in the *muḍārabah* contract where the entrepreneur (*muḍārib:* bank management) uses the funds provided by the financier (*rabb-al-māl:* depositor and shareholder). Both of them need each other – the entrepreneur needs the financier because he himself has the skills but not the capital, while the financier needs the entrepreneur because he himself has only the financial resources but not the time or the skills and energy to employ them profitably in business. However, in spite of this mutual dependence, there is conflict of interests. The entrepreneur may not necessarily employ the funds effectively and, even if he does so, he

34 Shleifer and Vishny, 1997; and Berglof and Von Thadden, 1999.

35 Some of the most notable of these studies have been a series of papers by La Porta, Lopez-de-Salinas, Schleifer and Vishny (LLSV), summarized in LLSV, 1999; and international cross-sectional studies by LLSV, 1998; LLS, 1999; Pistor, 1999; Claessens, Djankov and Lang, 1999; and Becht and Roell, 1999.

36 Dyck, 2000, P.25.

37 Ciancanelli and Gonzalez, 2000, P.3.

may wish to give as small a proportion of the rewards to the financiers as he can. There are many clandestine ways of reducing the financiers' share of profit. The financiers, on the other hand, may wish to get as much as possible. If the relationship between the two can be built on honesty, efficiency and equity, then a durable equilibrium can be created and this will serve the interests of both as well as the economy at large. Effective corporate governance needs, therefore, to be evolved in the Islamic financial system, as in any other system, with the objective of serving the interests of all stakeholders in an equitable manner.

2.3 A Comprehensive Contract

One pillar of such a system of effective corporate governance may be the clear specification in the *muḍārabah* agreement of how the funds will be employed by the *muḍārib* and how the returns will be shared by him and the *rabb al-māl*. The comprehensive contract that this may demand, is technically not feasible and not even desirable. It is not feasible because it would require perfect knowledge of market conditions as well as future contingencies on the part of both the principal *(rabb al-māl)* and the agent (*muḍārib).* The agent would tend to have better knowledge of market conditions than the principal, but they may both be unaware in different degrees of future contingencies. It is also necessary to take into account agency costs which are incurred to structure, administer and enforce contracts. It would be desirable in the interest of both to minimize these and keep them at a bearable level.

The agency costs have been broken down by Jensen and Meckling into three components.[38]

1. Monitoring expenditures by the principal to regulate the agent's conduct.
2. Bonding expenditures by the agent to help assure the principal that the agent will not take actions which would damage the interest of the principal and will indemnify him if such actions are undertaken.

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[38] Jensen and Meckling, 1976.

3. Residual loss, which covers the loss to the principal, in case the agent's decisions deviate from the decision which would have been made by the principal if he had the same information and talent as the agent. While the first two are out-of-pocket expenses, the third is also a real expense, even though it is difficult to measure.

Nevertheless, it may not even be desirable to tie the hands of the agent through a comprehensive contract. It would rather be wise to allow him some discretion. This would contribute to not only more efficient management of funds but also better handling of contingencies. However, such a leeway would not be granted if a climate of mutual confidence does not prevail, and this may be to the detriment of both.

The question is that, if a comprehensive contract is neither feasible nor desirable, then how could the principal prevent the agent from using the resources to further his/her own vested interest at the expense of the principal? The agent's actions may range from outright embezzlement or fraud to more subtle means of expropriation, such as unusually high perks and commissions and benefits granted to his/her own businesses of which the principal may not be aware. How could the destabilizing effects of asymmetric knowledge on the efficient functioning of the m*uḍārabah* be overcome? There were, as indicated earlier, a number of mechanisms which helped minimize fraud and mismanagement and reduce agency costs in the Classical period. While some of these are still present and their functioning can be improved, the social setup is not present. Some measures proposed in the literature for effective corporate governance can help fairly successfully in filling the vacuum. Some of the proposed measures which could be particularly helpful in modern-day are:

1. Market mechanism;
2. Moral integrity on the part of bank managers and directors as well as users of bank funds;
3. An enabling social environment;
4. Legal and institutional checks to make it difficult for the agent to violate the letter and spirit of the contract and to ensure fairness, honesty and efficiency in the use of funds;
5. An important role by the supervisory authorities and courts to ensure the fair and effective enforcement of

muḍārabah contracts irrespective of the position of any of the parties concerned in the social and political hierarchy; and

6. Establishing the shared institutions that are necessary for enabling the system to work.

2.4 Market Discipline

The most effective incentive and deterrent is market discipline. This is recognized by practically all classical Muslim scholars. Our Survey also indicates that depositors of Islamic banks would withdraw their deposits if these banks fail persistently to give comparable rates of return and do not comply with the *Sharī'ah* (Table 3.9). This implies that every bank has to build a good reputation for itself to attract depositors and to retain them. This may be achieved by improving the bank's services to its clients, sustaining a 'satisfactory' rate of dividend, and ensuring compliance with the *Sharī'ah*. Thus inefficiency and dishonesty are not inevitable in the changed environment. Market discipline was an important factor in helping accomplish this in the past and there is no reason to assume that this cannot be effective again in raising and sustaining the shareholders' and depositors' share value and enabling the bank to expand. Expansion will generate economies of scale, which will in turn reduce costs, and raise profits. The Board of Directors as well as Management will both then be able to serve their self-interest by being able to get better remuneration.

Private ownership of banks, prevalence of competition in the financial markets, and absence of political and judiciary corruption are, however, necessary to enable the market mechanism to be effective in pushing Management towards honesty and efficiency. It will also restrain the dominant shareholders in the excessive pursuit of their self-interest. They will be under pressure to push the Management towards better results. There is no escape, therefore, from market discipline if corporate governance is to be improved. But market discipline may be ineffective if it is possible for banks to manipulate accounts such that the balance sheet and profit and loss statement do not reflect the true condition of the bank. It is here that external auditors, regulators and supervisors, and moral values have an important role to play, as will be discussed later.

The users of bank funds will similarly be under compulsion to declare their profits truthfully to the banks, provided that there is a large number of entrepreneurs seeking funding from banks. Only those who are honest and efficient will be able to ensure continued availability of financing. Since the availability of finance is like lifeblood for businesses, market forces will be able to ensure honesty and efficiency in a system relying on the PLS. Since banks would try to ensure honesty and efficiency in the use of their funds, all other investors may also be able to get a better return. This would help improve the confidence of investors in the fairness of the market and thereby provide a boost to investment. In contrast with this, if funds are available easily to businesses from banks on the basis of a predetermined rate of return, the pressure that banks can exercise on corporations as a result of their own interest being at stake becomes diluted and the corporations may not, then, be under pressure to give better value to their shareholders. There is, hence, a genuine feeling that: "In recent years, corporate dishonesty has been encouraged by the availability of easy money."[39] Islamic finance, relying primarily on the PLS and assets-based financing, should, hence, be able to introduce greater market discipline not only in the financial markets but also generally in corporate management.

Well-functioning competitive markets are, therefore, indispensable for effective corporate governance in all banks, including the Islamic. Nevertheless, it is not possible to place total reliance on the market. There are a number of clandestine ways of cheating and constraining competition that can frustrate the operation of market forces. The bank may in particular be able to violate the interests of some financiers and not care to lose them as customers in the hope that its strong advertising campaign will help it gain resources from other customers. This is possible because of market imperfections. Information about its bad performance with some customers may not necessarily reach all members of the bank's constituency.

2.5 The Moral Dimension

Market discipline needs, therefore, to be made more effective by a number of measures, all of which are crucially important. One of these

39 *The Economist*, "A Survey of Management", 9 March 2002, P.9.

is greater moral discipline on the part of all operators in the market. Roepke has rightly argued that:

Self-discipline, a sense of justice, honesty, fairness, chivalry, moderation, public spirit, respect for human dignity, firm ethical norms – all of these are things which people must possess before they go to the market and compete with each other. These are the indispensable supports which preserve both market and competition from degeneration. [40]

Hence, it is not enough just "to invoke the laws of the market", it is also necessary to have higher ethical values."[41] It is these values which lead to self-enforcement of promises and contracts. Without such values and a motivating mechanism to induce individuals to abide by them, the costs of enforcing contracts and promises would rise and the operation of market discipline would become blunted. In fact, no human institution, leave alone banks and corporations, can operate effectively, in spite of itself being sound and healthy, if the human being, who is the end and means of all these institutions, is not sufficiently reformed.

Muḍārabah and *mushārakah* are both, hence, treated in the *fiqh* literature as fiduciary contracts *('uqūd al-amānah)* and unblemished honesty and fairness are considered absolutely imperative. Moral values needed for this purpose are clearly specified in the Qur'ān, the Sunnah and the *fiqh*. The Qur'ān requires the honest fulfillment of all contracts (al-Qur'ān, 5:1) irrespective of whether these are written or oral, and explicit or implicit. It prohibits betrayal of all trusts (al-Qur'ān, 8:27) and considers it immoral to derive any income by cheating, dishonesty or fraud (al-Qur'ān, 4:29). It prohibits the giving of bribes to derive an undue advantage (al-Qur'ān, 2:188). The Prophet, peace and blessings of God be on him, made it abundantly clear that "Whoever cheats is not one of us (i.e. not a Muslim)."[42] The bank itself, as principal as well as agent, and the users of bank funds (agents) must act in good faith for the benefit of all stakeholders. Any effort on the part of managers and

40 Roepke, 1977, P.60.
41 *Ibid.,* P.59.
42 Narrated from Abū Hurayrah by al-Mundharī (Mundharī, Vol.2, P.571, No.1) on the authority of Muslim.

directors of banks or users of bank funds to cheat and derive an unfair share of income is in utter violation of Islamic teachings.

However, moral values are just behaviour norms and will not be effective unless they get implemented. There are three requisites, in addition to market discipline, for ensuring their enforcement. One of these is the existence of a strong motivation for the self-enforcement of these values in the parties concerned. What can help greatly in this task is the innate goodness of the human-beings themselves. Within the framework of Islamic beliefs, human beings are good by nature (al-Qur'ān, 30:30 and 95:4).[43] They need not necessarily be unfair and dishonest. However, because they are also free and influenced by their environment, it is possible that they may be beguiled away from doing what is right.

A second requisite is a system of other-worldly as well as this-worldly incentives and deterrents. Reward and punishment in the Hereafter, which get no mention in a secular system, are essential as incentives and deterrents for making people abide by moral norms under all circumstances, even if this hurts their self-interest in this world. People may commit fraud and injustice and not get detected and punished. They may also do something good for general well-being at a great personal sacrifice but not get rewarded in this world. Belief in the Hereafter, therefore, has the potential of creating an inner urge in the individuals to abide by moral norms. This is because God has the knowledge of all our deeds and He will not fail to render justice to everyone. However, the reward and punishment in the Hereafter are not observable in this world and may not be able to influence the conscious mind of all individuals in spite of their apparent belief in these. They may not, therefore, always do what is right and abstain from doing what is wrong. This makes it necessary to have this-worldly incentives and deterrents as well.

2.6 Enabling Socio-Political Environment

This leads us to the third requisite, which is an enabling socioeconomic, political, legal and institutional environment. Individuals

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43 See also the footnotes to these verses in the translations of 'Abdullah Yūsuf 'Alī and Muhammad Asad.

who lived in the Classical Islamic period were not different from their counterparts now. They were the same human beings. If Islamic values prevailed then, why can't they do so now? What has changed is not the basic human nature but rather the environment. It is, therefore, necessary to improve the overall environment such that those who violate the norms get socially ostracized. This would induce individuals to overcome temptations and act in conformity with their basic nature, which is good, and to do what is right and abstain from doing what is wrong.

Unfortunately, the observance of Islamic norms of behaviour is not as strong in the Muslim world as one would expect. The Survey tried to ascertain the ethical environment by asking questions related to the influence of corrupt practices on business transactions, the role of criminal groups in the economy, and the ability of law enforcing authorities to effectively combat criminal activities. The results (Table 2.13) indicate a considerable difference of opinion. While half of the respondents considered the ethical overlay to be 'excellent', a third found it to be 'poor', and the remaining considered it to be 'fair'. It may be possible to reconcile this difference of opinion on the ethical environment if we bear in mind the fact that it was considered to be excellent primarily in countries where regulation and supervision were more effective.

The socio-economic, political and moral decline in Muslim countries over the last several centuries, is responsible for the prevailing ethical environment.[44] As a result of this decline, the environment for proper upbringing of children as well as the social controls needed to insure compliance have become weakened. A majority of parents, and in particular mothers, who have a crucial role to play in children's upbringing, are not well-educated in Islamic norms. Institutional arrangements are grossly inadequate for such education. The stress in religious education also seems, unfortunately, to be more on appearances and trivialities than on the uplift of character. This has been one of the primary factors which have contributed to an increase in violations of Islamic norms.

[44] For disucssion of these see Ch. 6 on "The Causes of Muslim Decline" in Chapra, 2000, Pp.173-252.

Since those who violate the norms do not only not get socially ostracized, but are also in fact able to get prestige, the violations have become locked-in in Muslim societies through the operation of path dependence and self-reinforcing mechanisms. Hence the use of all means of education and social solidarity need to be adopted for raising the moral consciousness of individuals as well as society such that individuals do not violate Islamic norms, and those who do so, experience social disapproval instead of prestige. Without social support, moral as well as legal norms are not likely to be effective.

2.7 Legal and Institutional Checks

Within the framework of Ibn Khalduns' analysis of the rise and fall of civilizations, the prevalence of justice is of crucial importance for promoting development.[45] Justice demands, among others, honest fulfillment of all contracts as well as other socio-economic and political obligations. This would be possible in the corporate and banking sectors if an enabling moral and social environment is reinforced by legal and institutional checks along with an honest and efficient judicial system to protect the rights of all stakeholders.

One of the most important institutions of corporate governance is, hence, legal protection for stakeholders. Countries with better investor protection have better-developed financial markets and higher growth. They may also be less prone to economic crises.[46] Consequently, legal protection has become an important variable of policy in most countries during the 1990s. Such protection, if effective, can exert a profound influence on the willingness of savers to invest in banks and corporations. The work of La Porta, Lopez-de-Salinas, Schleifer and Vinshy (LLSV) (1999a) has focused attention on those elements of the company code that favour minority shareholders in corporate decision making as opposed to Management or dominant shareholders. The nature and effectiveness of these mechanisms are discussed in a large volume of literature.[47] Some of the most essential legal and institutional mechanisms for effective corporate governance are related to the Board of Directors and Management, internal controls, effective risk

[45] For details of Ibn Khaldun's analysis, see Chapra, 2000, Ch.5, Pp.145-72.
[46] LLSV, 1999a.
[47] See Weston, Chung and Hoag, 1990, for an excellent overview.

management, adequate transparency, and accounting and auditing standards.

One of the most important concerns of law is to provide legal protection to 'outsiders' (minority shareholders, depositors and other stakeholders). This is necessary, along with institutional checks, to reduce the opportunity for managers and directors to serve their vested interests. However, even the existence of such legal protection should not create a sense of complacency because, as indicated earlier, there are so many clandestine ways of depriving shareholders and depositors of their value and of avoiding detection by the auditors and supervisory authorities that both market forces and supervision may be ineffective unless there is an inner urge on the part of agents themselves to fulfil their commitments faithfully. In societies where there is no conflict between moral norms and social behaviour patterns, moral norms as well as laws get enforced because, as Cooter (1997) has rightly put it, "officials lack the information and motivation to enforce the law effectively on their own."[48]

Legal protection tends to be ignored when the law is inconsistent with the 'actually prevailing' moral and social behaviour pattern. There is a growing recognition of the close relationship between behavioural patterns and legal institutions. Consistency between moral and social norms and actual behavior is considered to be indispensable 'social capital'.[49] Without such capital the costs of implementation of legal reforms would tend to be unbearably high.

Such social capital does not seem to be adequate in Muslim countries. Therefore, new laws will not by themselves be able to provide the necessary protection to stakeholders and stimulate financial restructuring. Changing a culture is necessary. Moral reform in Muslim countries is, however, likely to take some time. Nevertheless, the imposition of improved legal and institutional checks cannot wait until then. Legal and institutional reforms should be introduced as soon as possible, because only about 36 percent of the respondents considered legal procedures to be 'good' or 'excellent' while others considered them to be fair (43 percent) or poor (21 percent). (Table 2.12). However, while

48 Cooter, 1997, P.191.
49 For a valuable discussion of social captial, see Dasgupta and Serageldin, 1999.

streamlining legal protection for investors, we should bear in mind the stark reality that, in the last analysis, it may not be possible to ensure honesty and fairness in contracts without the help of moral values and their implementation through a self-reinforcing mechanism reinforced by an enabling social environment and impartial judiciary.

Getting back to Ibn Khaldun's analysis of the rise and fall of governments and civilizations, moral norms, which emanate in his analysis from the *Sharī'ah* in a Muslim society, may not get reflected in laws, and the laws may not get implemented effectively if the political authority does not attend to this task seriously. [50] It is the responsibility of the political authority to check all morally objectionable behaviour - dishonesty, fraud and unfairness - that is harmful for socio-economic development. It must also ensure the fulfillment of contracts and respect of property rights, and inculcate in the people qualities that are necessary for social harmony and development with justice.[51] What may be important within the Islamic perspective is not just the holding in check of objectionable behavior *(nahī 'an al-munkar)* but also the promotion of desired behaviour *(amr bi al-ma'rūf)* by the creation of a proper enabling environment through effective educational, political, social, legal and economic reforms and the building of proper institutions for this purpose. The governments generally fail to perform these tasks if they are not accountable before the people, do not apply the law equally and equitably on all the different strata of the population, and do not employ staff on the basis of character and competence.[52] Ibn Khaldun has devoted to this question a whole chapter entitled "Human Development Requires Political Leadership for its Proper Ordering"[53] in addition to substantial discussion in several other chapters.

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50 Ibn Khaldun, *Muqaddmah*, Pp.190-1.

51 It is only recently that the political dimension of economic reform and development has started to receive analytical attention. Douglas North emphasized that the only way economies can develop optimally is to keep 'nasty' behaviour in check. Governments are capable of doing this. If they do not, individuals may behave in ways that could undermine the very foundation of the system and lead to social chaos and economic collapse (See the Chapter, "Ideology and the Free Rider", in North, 1981). John Williamson has also focused on the political context of successful economic reform by analyzing 11 developed and developing countries (See Williamson, 1993).

52 Ibn Khaldun, Mu*qaddimah,* Pp.235-43.

53. Ibn Khaldun, *Muqaddimah,* Pp. 302-11.

3

MECHANISMS FOR CORPORATE GOVERNANCE

3.1 Board of Directors

Irrespective of whether an enabling moral, social, legal and political environment is available, the Board of Directors has a strong role to play in corporate governance. It cannot, however, perform this role effectively if its members do not have a reputation for moral integrity and are not technically qualified. They must be adequately aware of the risks and complexities involved in the banking business, and must try their level best to adhere to professional standards. In an Islamic system, they must have the additional qualification of being aware of the *maqā ´´`id al-Sharīʿah* as well as the Islamic teachings related to business and finance.

It is the responsibility of the Board to perform a number of functions without interfering in the day-to-day management of the bank. For this purpose, it must meet regularly and retain full and effective control over the affairs of the bank. It must hold regular discussions with Senior Management and internal audit, establish and approve policies, and monitor the progress toward corporate objectives. The supervisory authorities can be very helpful by specifying the functions that the Board is expected to perform. Every Board may adopt this list with appropriate modifications in keeping with its own circumstances and stage of development.

One of the Board's crucial functions is to clearly specify the strategic objectives and guiding principles for the bank, codes of conduct for Senior

Management, and standards of appropriate behaviour for the staff. Doing this would not be meaningful unless it also tries to ensure that these objectives are realized, that there is compliance by all with the codes of conduct, and that bribery, corruption, fraud, mismanagement and inefficiency are eliminated in a way that helps safeguard the interests of all stakeholders. It must assign duties and responsibilities to a hierarchy of decision-making authorities as well as its own members. It should ensure adequate transparency in keeping with the standards laid down by the Basel Committee on Banking Supervision (BCBS), the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Islamic Financial Services Board (IFSB), and the supervisory authorities, through a smooth flow of relevant information to directors, Senior Management, auditors, supervisors, shareholders, depositors and the public according to the needs of each with a view to ensure a proper check on the affairs of the bank. It should adopt corrective measures promptly in case of any deviation. It should properly evaluate the quality of the users of bank funds and of its own performance.

The Board will not be able to carry out its responsibilities effectively if it fails to establish a strong internal control system, proper accounting procedures, effective internal and external audit, efficient risk management, and all necessary checks and balances, rules, regulations and procedures. It should also ensure that all appointments, particularly to Senior Management positions, are according to merit without any favoritism or nepotism. It would be appropriate to cite in this connection two *Ḥadīths* of the Prophet (peace and blessings of God be on him):

- Whoever employs a person out of favoritism (*‘a ´'`ābah*) when there is someone who is

better than him, has committed a breach of trust with God, His Prophet and all Muslims.[54]

- Whoever has been invested with authority on any affair of Muslims, but appoints over them someone out of favoritism, faces the curse of God. God will not accept from him any ransom or compensation and will send him to hell.[55]

It will not be possible for the Board to perform all these tasks effectively if it is concerned only about its own benefits and does not act as a guardian of the interests of all shareholders, depositors, employees, and other stakeholders. Supervisory authorities as well as external auditors can play an important role in ensuring that the Board actually performs these tasks.

Unfortunately, directors do not necessarily play their roles effectively.[56] There are a number of reasons for this. One of these is that Board members may not always have the professional competence and the moral integrity that are needed to manage a bank. Even though the existence of these qualities in Board members is important in all banking systems, it is of crucial importance in an Islamic system, which derives its raison d'être from a humanitarian moral base rather than the severing of self-interest. Another reason is that Board members are not always genuinely elected by shareholders and are not necessarily accountable before them. Elections do not take place regularly at defined intervals and, even if they do, the available evidence indicates that shareholders are not actively involved in the election or removal of directors.[57] This enables board members to perpetuate themselves and it is generally difficult to dislodge them except through takeovers. These

54 Narrated from Ibn 'Abbās on the authority of al-Ḥākim by al-Mundharī (Mundharī, 1986, Vol.3, P.175).

55 Narrated from Abū Bakr al-Ṣiddīq on the authority of al-Ḥākim by al-Mundharī ((Mundharī, 1986, Vol.3, P. 175).

56 Mace, 1986.

57 Prentice, 2001, P.31.

are, however, expensive and potentially disruptive and, may not, therefore, be a possible remedy except in extreme cases.[58] To correct this situation, it is necessary to have a transparent procedure for elections and to adopt measures that would enable small shareholders to have a say in Board decisions. It is also necessary to enable shareholders to remove Board members in the event of their performance falling far short of what they expect.[59]

The problem, however, is that democracy, which is a valuable characteristic of many countries, is generally not reflected in their corporate boardrooms. The size and structure of the Board along with proxy rules have a great deal to do with it. To ensure democracy as well as efficiency and equity, the Board should have a sufficient number of both executive and non-executive directors truly elected by shareholders. Executive Directors combine the role of directors with responsibility for management. They help promote efficiency through their intimate knowledge of the market as well as the company's affairs. However, If the Board is dominated by executive directors, the difference between the Board and the Senior Management disappears and the interest of outsiders tends to be jeopardized.

Non-executive directors who do not have any management responsibility and may not, therefore, have a vested interest in protecting the Management, may be expected to attach greater weight to the interests of 'outsiders' and, thereby, help inject equity into the company. If they do not come up to this expectation, they would hurt their own reputation in the directors' labour market. Empirical evidence in the conventional system indicates that non-executive directors influence positively a Board's capabilities to evaluate and discipline managers.[60] Removal of the Chief Executive Officer (CEO) caused by poor performance is more likely in outsider dominated Boards than in insider dominated ones. However, here too there are problems. If the non-executive directors have not been elected by shareholders but rather handpicked by the dominant shareholder or the CEO, they would owe their careers to him and would, therefore, "lack the information and

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58 Morck, Shleifer and Vishny, 1990.

59 The role of depositors in this is discussed later.

60 Alvarez, et. al., 1998, P.2.

incentives required to provide consistent effective corporate governance."[61] There will, thus, be conflict of interest, which will create a lack of willingness on their part to discipline Senior Management.[62] Moreover, Board meetings may not be frequent and non-executive directors may not, therefore, be able to monitor the activities of the company effectively and ensure correction, particularly if overt criticism of Management policies in Board meetings is considered to be rude.[63]

In those developing countries, where even political democracy does not exist truly, its existence in corporate boardrooms is even less likely. Since even market discipline is weak in such countries and legal checks and balances either do not exist or do not get effectively enforced, it becomes possible for big shareholders and Management (insiders) to exploit the corporation for serving their own vested interest. They are able to expropriate as much of the cream as they can for themselves, leaving little for other stakeholders (outsiders).

It is, therefore, imperative to institute reforms in election procedures as well as proxy rules to enable shareholders to elect competent and conscientious persons to the Board of Directors and to prevent them from perpetuating themselves in spite of their poor performance. It is also necessary to develop a legal and regulatory infrastructure to protect the rights of not only small shareholders but also depositors (both being outsiders). In a number of countries companies are allowed to ask registered shareholders, who are unable to attend general meetings, to transfer their votes to the Board of Directors. This further strengthens the hands of the Board and enables it to control decisions at shareholder meetings. Since the transfer of voting rights often leads to far-reaching consequences, which may not always be in the interest of all stakeholders, it would be desirable to transfer voting rights to shareholder associations, if they exist. If such associations do not exist, then voting rights may be transferred to supervisory authorities or to specialized chartered firms established in the private sector to protect the interest of stakeholders against a fee. (*This is discussed later*

[61] Herzel, 1994, P.472.
[62] Sykes, 1994, P.118.
[63] Morck, 1994, P. 476.

on in Section 3.3). All three of these institutions would perhaps be better qualified to protect the interests of stakeholders.[64]

East Asian experience has shown that the factor that contributes to control of corporations by large shareholders is the extensive use by them of debt financing. Banks, being assured of a predetermined rate of return on their loans along with collateral to ensure repayment, do not generally take a keen interest in the affairs of the corporation as much as they would tend to do if they were shareholders rather than lenders. This reduces the pressure for good governance, and is particularly true in the case of banks because their leverage is high and even 'adequate' capital constitutes a small proportion of the total resources available to them. This situation will continue even when the reforms proposed by the BCBS get earnestly implemented. When high (insider) ownership concentration joins hands with poorly competitive financial markets, then the legal protection provided to minority shareholders, while extensive on paper, does not normally have enforcement muscle. This does not only impose high and severe costs on the economy but also sows the seeds of financial crises and social unrest.

In addition to reform of election procedures and proxy rules and the participation in risk by both investment depositors and banks, it would also be desirable to introduce some other reforms to make the Board of Directors more effective in its functions. One of these, which needs to be considered seriously, is to relate the remuneration of Board members to their performance in the same way as required in *muḍārabah* contracts.[65] The directors in their capacity as *muḍāribs* should be compensated for only their actual expenses and not be entitled to a fixed management fee or remuneration as they do in modern corporations. Their remuneration should be a certain percent of the profit earned by the bank, if the bank has made a profit. This must be in addition to their normal share in profit like other shareholders on the

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64 In Germany it is customary for individual shareholders to transfer their voting rights to banks or to shareholder associations who send their representatives to the meeting (Balling, et. al., 1998, P.xxii).

65 The *muḍārabah* form of business allows only normal expenses of the *muḍārib* to be charged to the *muḍārabah* account. The *muḍārib* is not entitled to a fixed remuneration or an absolute amount of profit specified in advance. His only entitlement beyond the normal expenses of business is a mutually agreed share in profit as a reward for his management services.

basis of their shareholdings. The percentage share of profits to be allocated to the directors for their Management services must be clearly specified in the Articles of Agreement so that it is well-known to the shareholders. If the corporation makes a profit, the directors get the specified percent of profit for their services. But if the corporation makes a loss, the directors do not, like the *muḍārib,* get a 'fee' for their management services, and should share in the losses in proportion to their stockholdings. The directors would thus get a reward for their services only if they have contributed to profits – the higher the profit, the greater their reward. This should prove to be an incentive to them for better performance.

The directors should also be prevented legally from making 'secret' profits for themselves. They should not be allowed to manipulate share prices or to get an undue advantage from their insiders' knowledge of bank affairs. The adoption of these reforms should prove to be healthy because they would help do away with some of the malpractices that have crept into the corporate form of business. The more the performance of corporations improves, the better will be the climate for investments in equity by banks as well as other investors. Implementation of the desired reforms will, of course, be a difficult task, particularly because violations are resorted to in such a skillful manner that it is difficult to detect them. Hence, unless the moral consciousness of the directors is strong, legal reforms may not be as effective as desired.

The Survey results with respect to the Board indicate that the average size of the Board in our sample is around 12, with a maximum of 27 and a minimum of 4 (Table 2.4). The number of Executive Directors is generally small – the average being 2, with a maximum of 7 and a minimum of zero. There is, however, a great deal of concentration of shares in the hands of directors. Their average shareholding is 29.1 percent (Table 2.4), with the largest single shareholder having an average of 25.2 percent of the shares and the largest 5 and 10 shareholders having an average of 51.7 percent and 62.5 percent of the shares (Table 2.3). One of the major reasons for such concentration is the small size of Islamic banks as compared with their conventional counterparts even in Muslim countries, leave alone the rest of the world. The average value of their assets is US$ 412.2 million, with the largest bank having assets of US$ 1.64 billion and the smallest having assets of

only US$ 28.2 million. The amount of capital held by banks in our sample is accordingly small, the average being US$ 74.4 million, with a maximum amount of US$ 348.7 and a minimum of US$ 5.0 million (Table 2.2). This raises the question of whether it is concentration of shares which is responsible for the 'excellent' performance of the Board in 50 percent of banks and for the 'good' and 'fair' performance in 36 and 7 percent respectively in our sample (Table 2.8). While the incentive provided by concentration may have been a factor, the better regulation and supervision of those banks seems to have been the primary reason. Since the small size as well as the concentration of shareholdings carries the potential of leading to undesired consequences for protecting the interests of all shareholders, it would be desirable to institute legal reforms, one of which is the promotion of a relatively larger size of banks with the objective of reducing concentration, diversifying risks and increasing their ability to absorb losses.

3.2 Senior Management

While the expression Board of Directors, as used above, refers to persons who are generally not only shareholders themselves but also participate in the governance of the bank, Senior Management refers to the CEO and other senior members of the staff who perform management functions but are not necessarily shareholders. Modern corporations are in general not managed by their owners (shareholders).[66] Instead, professional managers are hired to run the business. They are 'fiduciaries.[67] This creates, as indicated earlier, the principal/agent problem and leads to a conflict of interests. It is, therefore, necessary to impose restrictions on self-dealing, fraud, excessive compensation in different hidden forms, and other malpractices.

Management is responsible for the day-to-day functioning of the bank. It is accountable before the Board of Directors, which has the legal authority to appoint and remove the concerned officers. Just as it is necessary to clearly specify the functions of the Board and its members, it is also necessary to regulate the behaviour of managers to ensure that

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[66] Berle and Means, 1932; and Jensen and Meckling, 1976.

[67] A fiduciary is "a person who is entrusted to act as a substitute for another person for the sole purpose of serving that person" (Iwai, 2001).

they do not act in a way that would hurt the interests of shareholders and depositors. A number of mechanisms have been developed for this purpose with a view to minimize the conflict and to protect the interests of all stakeholders. The nature and effectiveness of these mechanisms are the subject of a large volume of literature which it is neither possible nor desirable to summarize here.[68]

One of the most important responsibilities of Management is to appoint the best available personnel for different jobs without any favouritism or nepotism. It is also its crucially important responsibility to establish, and effectively operate, a permanent internal audit system as well as risk management and control procedures, and to ensure that they are being effectively complied with.

The internal audit function should be conducted independently. Every activity and every division should fall within the scope of internal audit. The professional competence of each internal auditor is essential for the proper performance of the internal audit function. Therefore, the internal audit function should be adequately staffed with persons who have the appropriate skills and technical competence and are also free from operating responsibilities. The internal audit function should regularly report to both the Board of Directors and the Management about its performance. The Board should ensure that the Management gives serious consideration to this report and effectively implements its recommendations. The Board should also ensure that the internal audit function is not under pressure from Management to produce an unduly favourable report.

Since the CEO and the Chairman of the Board perform two distinct functions in the bank, it would be preferable to have two different persons holding these positions so that there is a clear division of responsibilities at the top of the bank to ensure independence and balance of power and authority. One of the most important constraints on Management is that key decisions should not be held by one person ('four eyes principle') and that neither the Directors nor the Management should be allowed to stay on the job if they are no longer competent or qualified to run the bank. As argued by Jensen and Ruback, poor

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68 Weston and Hoag, 1990, provide an excellent overview. For some useful accounts of comparative corporate governance see, Iwai, 2001.

managers who resist being replaced might be the costliest manifestation of the agency problem.[69] We are glad to report that all banks covered by our Survey indicated that the positions of CEO and Chairman were held by different persons.

To be able to perform its role effectively, Management should have all the three indispensable virtues, which the Qur'ān and the *Sunnah* have greatly emphasized, and which are also generally accepted as the minimum criteria for good management.[70] These three virtues are: honesty, frugality and preparedness. The Qur'ān and *Sunnah* are full of statements to this effect. The following two *ḥadīths* are quoted just by way of example: The Prophet, peace and blessings of God be on him, said: "A hypocrite has three signs: when he speaks he tells lies; when he makes a promise he does not fulfil it; and, when he is entrusted with something he commits a breach of trust."[71] He also said that: "An honest and trustworthy businessman will be with the Prophets, the truthful and the martyrs on the Day of Judgement."[72]

While every person is expected to be honest at all times and in all matters, it is extremely important for bank management to be honest because they are trustees of funds entrusted to them by shareholders and depositors. Honesty would require Management to be fair and transparent and would, in turn, enable the Management to gain the trust and confidence of all stakeholders. Once Management starts deceiving, it starts weaving a tangled web around itself. This has been clearly revealed by Enron, Worldcom, Lucent, Xerox and some other corporations, the affairs of which have come to light in recent years. Deceipt demands more deceipt until the structure collapses under its own weight. Even a small deception can become troublesome when it needs further deception to keep it hidden.

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69 Cited from Jensen and Ruback (1963) by Schleifer and Vishny, 1997, P.743.

70 See, *The Economist*, 9 March 2002, P.3.

71 Narrated from Abū Hurayrah by al-Mundharī (Mundharī, Vol.4, P.9, No.13).on the authority of both al-Bukhārī and Muslim. However, Muslim also adds at the end: "even though he prays and fasts and considers himself to be a Muslim"

72 Narrated from Abū Sa'īd al-Khudrīyy by al-Mundharī (Mundharī, Vol. 7, P.585, No.1) on the authority of al-Tirmidhī (in his Awsaṭ) and Ibn Ḥibbān (in his Ṣaḥīḥ).

There are a number of reasons for corporate dishonesty. One major reason is "the availability of easy money."[73] The question is why? The reason may perhaps be that the availability of easy money enables Management to spend lavishly until this can no longer be continued. Shareholders would come to know of this when it is too late for reform. Lenders have their own contracts to protect themselves and have, in general, little influence on, or concern with, corporate governance. The availability of resources largely on a PLS basis would tend to have a restraining effect on such lavish spending.

A number of measures may be taken to promote corporate honesty . One of these is frugality among the bank's officials and staff.[74] Living beyond means and being constantly under a debt-servicing burden creates an urge to get resources by any means, including deceipt. A second measure is an effective internal controls system to nip in the bud all attempts to cheat. A third measure is to encourage whistle blowers to draw attention to suspected behaviour by anyone in the bank. The problem, however, is that instead of getting rewarded, whistle blowers tend to be bullied and harassed and may even lose their jobs. External auditors could have been a great help but, unfortunately, they also sometimes become an integral part of corruption when they have a vested interest in protecting Management, the Board is not independent of Management, and the shareholders as well as directors are also unable to play an important role in ensuring accountability.

Frugality on the part of the bank itself is also indispensable because extravagance leads to excessive borrowing and debt servicing as well as lower returns to shareholders and depositors unless the bank starts investing in risky ventures to raise its profits. This may itself land the bank into serious trouble when ruthless downsizing becomes unavoidable to reduce losses. Among the first to suffer from such downsizing are employees who have had nothing to do with the bank’s losses. This is unfair to them and is not acceptable in a system whose

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[73] *The Economist*, “A Survey of Management”, 9 March 2002, P.9.

[74] .The Qur’ān has emphasized moderation in spending (abstaining from extravagance as well as niggardliness) in several verses. See, for example, al-Qur’ān, 6:141, 7:31,and 25:67.

raison d'être is justice. Some US companies have done extraordinarily well by adopting frugality as a guiding principle.[75]

Preparedness for all eventualities is also indispensable in a world where change is said to take place at the speed of light. The Qur'ān has urged Muslims to be always on their guard (al-Qur'ān, 4:71). One of the important ways of living up to this principle by Management is to give top priority to strategic planning, which is concerned with long-term rather than short-term goals, to ensure success and prevent problems in the future. Strategic planning would make Management concentrate on training the staff, and giving them better terms to ensure their efficiency and longevity, improving services to customers, adopting better technology, making provisions for adequate loss-offsetting reserves, building a good reputation, and increasing the bank's capability to meet all challenges in the future. Needless to say that, unless the bank Management is honest and frugal, it may not be able to spare resources for this purpose. Extravagance on the part of bank Management reduces the bank's ability to fund development and expansion and to be on guard for all eventualities.

Our Survey placed a great deal of attention on the Management of banks to determine the efficacy of its performance. Questions were designed to get information on the division of authority between the Board and the Management, guidelines and policies for different departments, risk management, internal controls and reporting systems, level of technology and training employees. The results indicate that only 21.4 percent of the banks had Management whose performance could be termed 'excellent' while that of 42.9 percent and 14.3 percent was 'good' and 'fair' respectively. The Management of 21.4 of the banks seems to be poor(Table 2.10). The results thus imply a great deal of room for improvement. This need will become more and more pressing as the banks expand, manage a larger volume of resources, and play a greater role in the financial systems of Muslim countries.

3.3 Shareholders and Depositors

It would seem strange to bracket depositors with shareholders. This is not done in discussions related to conventional financial

[75] *The Economist*, "A Survye of Management", 9 March 2002, Pp.4 and 14.

institutions. The primary reason for this is that in these institutions deposits are explicitly or implicitly insured and a positive rate of return is guaranteed. There is thus no question of any loss. There does not, therefore, seem any need to talk about the rights of depositors. It is only the shareholders, and in particular minority shareholders, who need their rights to be protected.

Islamic finance is, however, different. Investment depositors participate in the profit and loss like shareholders. They have, nevertheless, no voice in shareholders' meetings even though their deposits are generally far greater than shareholders' capital. Guaranteeing these deposits would be in conflict with the spirit of Islamic finance. Even though demand depositors are not exposed directly to the risks of banking business, they are exposed indirectly for two main reasons. Firstly, the deposit insurance system does not generally insure demand deposits beyond a certain limit; and secondly, the losses suffered by banks on their PLS advances may be substantial and the capital and reserves plus investment deposits may not be sufficient to cover them. This is, however, unlikely to happen except when demand deposits far exceed investment deposits, which is the case in a number of Islamic banks, or when a substantial proportion of investment deposits has been withdrawn, which is possible because banks generally allow the withdrawal of these deposits even before their maturity. Therefore, all precautions need to be taken to ensure continued confidence of depositors in Islamic banks. Negligence in this matter carries the danger of leading to not only the failure of individual banks but also systemic risk. Results of our Survey show that most banks do not perform well when it comes to protecting the rights of depositors and other stakeholders (Table 2.7).

Hence, the question is: how to protect the interests of both demand as well as investment depositors and to ensure their continued confidence in the banking system. Among the most important of these measures would have to be better macro-management of the economy along with efficient micro-management of banks under an umbrella of proper regulation and supervision. Another measure would be the minimization of all risks through proper management of the banks' resources. This is one of the major objectives of corporate management and is not only desirable but also necessary for maintaining the

confidence of depositors in the system. These measures need to be reinforced by the insurance of at least demand deposits.[76] It may also be desirable to ensure investment deposits, not against market risk, which the depositors must share, but rather the risk against fraud, mismanagement, and violation of the *muḍārabah* contract. There is, of course, a danger that this might lead to moral hazard on the part of investment depositors even though it would tend to make the insurance provider more vigilant.

Could the depositors' interest be protected by allowing them to have a representative on the Board of Directors and also a voice in the shareholders' meetings? The ease with which shareholders as well as depositors can participate in meetings and use their votes to influence important bank matters or to remove directors and Senior Management from office, can play an important role in improving corporate governance in banks. The problem, however, is that depositors are far more in number than shareholders. Even shareholders in non-bank corporations do not necessarily attend shareholders' meetings. It is, therefore, very unlikely that depositors would do so, particularly if the banks are large and have several branches not only within the country but also abroad. Moreover voting rights can be expensive for shareholders and depositors to exercise if they can do so only by attending the meetings. This would virtually guarantee non-voting.[77]

How can the depositors, then, protect their rights? One of the ways is to punish the banks by withdrawing their deposits when the banks do not give a competitive rate of return and do not comply with the *Sharīʻ*ah in their operations. Our Survey indicates that the depositors do this. The problem, however, is that such punishment may come when it is too late for them to protect themselves. It would, therefore, be better for them to have a voice in decision making. Is it possible and feasible for them to attain such a voice?

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[76] See Chapra and Khan, 2000, Pp.64-5.

[77] In the case of Grameen Bank in Bangladesh, loanees are required to buy the Bank's shares. Such shareholders are heavily represented on the Board (9 out of 13 Board members are poor women who have borrowed from the Bank). Such shareholders would not be able to exert any influence on Board decisions.

One of the ways towards this end would be for the regulatory authority to appoint a representative on behalf of depositors on the banks' Board of Directors? The banks would perhaps resent this even though this is important not only for safeguarding the interests of depositors and small shareholders but also for systemic stability. If such representation is ruled out, then it may be desirable to encourage the formation of depositors' associations to protect their rights. If this happens to be practically difficult, then it would be worth considering the establishment of specialized chartered firms in the private sector to protect the interests of depositors, just as it is the job of external auditors to protect the interests of shareholders. Their fee could be paid by the bank as a percent of the dividends distributed. An important objection against this suggestion may be that it would lead to an unnecessary proliferation of institutions. To avoid such proliferation, external auditors may be assigned the task. It will be cheaper and more convenient if the external auditors are required to act as guardians of not only the shareholders' rights but also those of the depositors'. It is also necessary to ensure that adequate transparency prevails so that the depositors know what is going on in the bank and are thus able to play a greater role in safeguarding their own interests.

It is also necessary to protect the interests of shareholders in the banks. These, according to the results of our Survey, seem to be well-protected (Table 2.6). The reason may perhaps be the concentration of ownership, which is generally prevalent not only in Muslim countries but also around the world. Four of the most cited studies in the literature on ownership structures around the world have shown that firms held by anonymous disperse shareholders are the exception rather than the rule.[78] In our sample also, the largest single shareholder owns 60 percent of the shares and the largest 5 and 10 shareholders own 92 and 99 percent of the shares respectively (Table 2.3)

Since justice and brotherhood and, hence, equitable distribution of income and wealth, occupy a key position in the *maqā ´`id al-Sharī'ah,* one would prefer to see a disperse ownership of shares in corporations as well as banks. This should be the ideal towards which one would wish

[78] These studies collected data on cash flow ownership for the same sample of 49 countries. The results are reproduced in Table 2 of the Appendix in Dyck, 2002, P.41; see also P.28.

the Muslim world to move. In the absence of disperse ownership, vested interests with concentrated ownership can have a free hand in exploiting their voting strength to dominate the affairs of the corporation. This is where legal protection becomes indispensable to provide strength to minority shareholders and raise their dividends. This would also make the market place a higher value on such shares.[79] Weak legal protection enables majority shareholders to redirect the resources of the corporation to their own advantage. Minority shareholders as well as depositors then get the residual which may be a proportionately much smaller share of the cream than what they should.

It is sometimes suggested that, in case disperse ownership does not exist, then it would be desirable to have more than one large owner. The problem, however, is that those in control, irrespective of how many they are, may collude in their own interest and it may be difficult to dislodge them if they are not motivated to serve the interest of all stakeholders. There is evidence to show that when ownership becomes concentrated there is danger of resources being diverted from small investors. Ownership concentration is, therefore not without potential cost.[80]

This is where universal banking makes a difference in protecting the rights of minority shareholders. A number of analysts have suggested that a key to the relatively better performance of German and Japanese corporate systems is the involvement of banks in the ownership and control structure of companies. Banks have the information, the ability to impose sanctions, and the incentive to use their powers, which minority shareholders can never attain.[81] Hoshi, et. al, have shown that Japanese firms with bank participation have greater access to capital and lower costs of resolving financial distress.[82]

In the Classical Islamic financial system, affiliation with the community, tribe, guild or sufi circle, as indicated earlier, played a key role in protecting investors. The investor knew the community or group affiliation of the individual or ´'`*arrāf* to whom he entrusted his

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79 Dyck, 2000, Pp.33-4.
80 Morck, Schleifer and Vishny, 1989.
81 Dyck, 2000, P.23.
82 Cited by Dyck, 2000, P.23.

resources. The community or the group, in its own long-run interest, imposed sanctions and insured honesty, thus giving confidence to investors that they will be able to get justice at low cost. Since such community ties and social networks are not available now, their beneficial effect needs to be derived through other mechanisms, one of which is bank affiliation.

Recent literature on the Japanese and German experience, however, sees problems in bank affiliation because it can lead to overlending and deferred restructuring.[83] When there is overlending the bank may try to protect its rights as lender rather than as shareholder. It may then be interested primarily in the indebted firm's ability to service the debt. It may block all projects with high risk but also high payoff. Debt driven monitoring may thus lead to socially inefficient outcomes. This problem would, however, tend to get minimized when the Islamic financial system comes of age, because banks would invest to a great extent on a PLS basis rather than lend heavily. Since the banks would then be participating in risk, they would be more careful in providing resources. The question of overlending would then tend to be minimized.

Bank participation in equity is better for another very important reason. Even if the ownership is disperse, it may not act as a check on Management because, as indicated above, small shareholders do not normally attend shareholders' meetings. If a bank is represented on the Board as a result of its equity holdings and this gets combined with effective regulation and supervision as well as external audit, the working of corporations would improve to the advantage of all stakeholders. While safeguarding its own interest the bank would unintentionally end-up protecting the interests of all outsiders, thereby raising the confidence of shareholders and leading to a rise in investments. Investment depositors also, like shareholders, would then be able to get a better return.

The major conclusion to be drawn from this discussion is that Islamic banking in its true form carries the potential of injecting a greater discipline in investment as well as finance and, thereby, helping reduce the magnitude of many of the problems that international finance is

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83 Weinstein and Yafeh, 1998.

facing. However, Islamic banks in their present stage of development cannot impose such discipline because of their small size as well a primary involvement in the debt-creating sales-based modes of financing.

There is also another aspect of safeguarding the rights of depositors. When they place deposits in Islamic banks, they want to be sure that what they are getting is not wine with the label of honey. It is, therefore, necessary to ensure the compliance of Islamic banks with the *Sharīʻah* in the acquisition as well as the use of funds. This is discussed later in section 4.5 on "*Sharīʻah* Clearance and Audit".

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TOOLS FOR CORPORATE GOVERNANCE

Since mobilization of financial resources by banks from depositors to advance to investors is crucial for the accelerated development of an economy, Cadbury (2001) maintains that it is necessary to balance this function by acceptable safeguards for those who provide the resources. The risks that banks and businesses take must be matched by sufficient checks and balances to boost the confidence of those on whom the working of the system depends.[84] To ensure such confidence in the system it is necessary to have effective internal controls, risk management, accounting and external audit, and transparency. It is now time to look briefly at all these tools of corporate governance.

4.1 Internal Controls System

The existence of an effective internal controls system is indispensable for the safety and soundness of all financial institutions, and Islamic banks cannot be an exception. Such a system can help ensure realization of the institution's goals and enhance its long-run profitability. Internal controls are also indispensable for ensuring Management oversight and developing a healthy culture within the institution. They are necessary for recognizing and assessing risks, detecting problems within the institution, and correcting deficiencies. If properly conceived, internal controls would cover all on- and off-balance sheet activities of the bank and not just some specific areas, and would be in line with the nature and complexity of the risks involved in the bank's activities. Experience has shown that the existence of effective internal controls could have prevented, or enabled early detection of, problems that a number of banks have faced, and thereby helped avoid bank failures and systemic crises. No wonder, the Basel Committee[85] as well as banking supervisors around the world have all focussed increasingly on the importance of sound internal controls.

[84] Cadbury, 2001.
[85] BCBS, September 1998.

It is essentially the function of the Board of Directors to ensure that an effective system of internal controls is laid down and conscientiously observed. Once such a system has been laid down, it is the job of Senior Management to develop processes that identify, measure, monitor and control all the risks (including credit risk, country and transfer risk, interest rate risk, market risk, liquidity risk, operational risk, legal risk and reputational risk) that affect the realization of the bank's goals. The Board and the Management should be together responsible for promoting integrity in the institute and creating a culture whereby all personnel understand the need to fulfil their responsibilities honestly and efficiently. Such a culture will not develop if there is favoritism, nepotism and lack of justice and fairness. These would frustrate the effective operation of incentives and deterrents.

The internal controls system needs to be monitored on an ongoing basis to ensure compliance with rules and procedures, exposure limits, approvals and authorizations, and verification and reconciliation. It will not be possible to implement the controls system successfully without an effective channel of communications as well as prompt and timely availability of crucial information about all significant activities of the bank and about external market conditions that are relevant to decision making. The internal audit system, which is an important part of internal controls, should be strong and independent and should report directly to the Board of Directors and Senior Management.

Once the internal controls system has identified the problems in the institution, it is the responsibility of Senior Management and the Board of Directors to promptly take corrective action. Procrastination on their part can be very harmful and should be penalized by supervisory authorities. Without such deterrent, the internal controls system would be in danger of having no more than a cosmetic existence.

It is one of the prime responsibilities of the supervisory authorities to ensure that there is an effective internal controls system in all banks in conformity with the nature and complexity of the risks involved in that specific bank's on- and off-balance sheet activities and the changes in the bank's internal and external challenges. External auditors, even though they are not an internal part of the financial institution, can exert an important impact on the quality of internal controls through their audit activities. They can provide an important feedback to Senior

Management and the Board on improving the internal controls system to make it more effective.

Our Survey indicates that 79 percent of Islamic banks have in place an internal controls system capable of dealing swiftly with newly recognized risks. There is also a separation of duties in 81 precept of the banks between those who generate risks and those who manage and control them. The banks thus get an overall grade of 87.1 percent or B+ on their internal controls system, which is quite good for a system which is still in its infancy.[86]

4.2 Risk Management[87]

A number of risks, as indicated earlier, are inherent in all banking business and Islamic banks cannot avoid being exposed to them. This is particularly so because of the high leverage in banking business. Since the rate of return on equity depends on the value of assets, it is the natural tendency on the part of banks to have as large a leverage as possible by continually expanding the volume of deposits against a small amount of their own equity. High leverage has the danger that even a small loss on assets may be enough to wipe out the bank's entire equity and cause it to collapse. As a result of the contagion effect, the collapse of even a single bank may become a source of serious systemic instability in the payments system, particularly if the bank happens to be large.

Therefore, in addition to keeping a constant eye on their capital to ensure that it is adequate, banks also need to be extremely cautious about their exposure to all the risks. This demands that they develop systems that would help in their proper identification, measurement, monitoring and control, and thus help in their effective management. The

86 The percentages given in this para are based on responses to questions in the questionnaires and do not appear in any of the tables in Part I of Appendix I.

87 There is only a brief discussion of the subject here. For a more detailed discussion, see Chapra and Khan, 2000, and Khan and Ahmed, 2001, from which the entire section on risk management has benefited. See also the references cited therein.

Board of Directors and Senior Management must be qualified enough to be fully aware of the risks involved in banking business and should make the development of a risk management culture an integral part of their responsibility. They must establish adequate risk mitigating procedures and reinforce these by effective internal controls.[88] This would happen effectively if supervisors of Islamic banks are also themselves well-versed in the nature of risks and take keen interest in promoting efficient risk management in the institutions under their supervision.

To facilitate proper risk management, it would be desirable to clearly separate the bank's banking book activities from the trading book activities. The former deals with the assets and liabilities of banks generated primarily by the mobilization of deposits and the employment of these to finance different users in suitable amounts and maturities. The trading book concerns the effort to diversify the bank's portfolio with a view to offset some of the risks emanating from the banking book and also to earn additional income by trading in securities and managing investment accounts and mutual funds. The trading book of conventional banks comprises transactions in interest, foreign exchange, commodity and equity-based instruments, most of these being derivatives. Since Islamic banks do not deal at present in derivative instruments, it is necessary to find some ways that would enable them to keep their risks within manageable limits. It is worth examining whether some of the derivatives could be permissible within the perspective of the *Sharī'ah* and used by Islamic banks to manage their risks.

Some banks may face difficulties in the present-day environment of volatility in the commodity, stock and foreign exchange markets in spite of proper risk management. This underscores the need for having adequate risk-weighted capital with a constant watch to ensure the maintenance of its quality. It is also necessary to have sufficient loss-offsetting reserves. Our Survey indicates that a formal system of risk management is in place in 81 percent of the banks and that different risk reports are prepared for the Board.[89]

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88 See some of the BCBS studies on the management of various risks listed in the "References".

89 These figures are also, like those on internal controls, based on answers to questions and do not appear in any table in Part I of Appendix I.

Some of the major risks to which Islamic banks can become exposed are discussed below.[90]

4.2.1 Credit Risk

Credit risk is perhaps the most serious risk faced by financial institutions. It arises from the inability of a debtor to settle the debt on time in accordance with agreed terms. This can give rise to not only a liquidity crisis but also a decline in the quality of the banks' assets.

A number of factors determine the level of credit risk faced by conventional banks. Some of the most important of these are: rating of the counter-parties, nature of the legal system, quality of collateral, maturity of credit facility, size of banking and trading books, utilization of credit derivatives, and internal control systems. Islamic banks face some additional risks as a result of their PLS and sales-based debt-creating operations, the differences of opinion among the *fuqahā'*[91], and their inability to use credit derivatives and reschedule debts on the basis of a higher mark-up rate. It is, therefore, necessary for Senior Management of Islamic banks as well as their supervisory authorities to have a clear understanding of all these risks and to pay due attention to them in their evaluation of the bank's condition. It is also necessary for them to give due attention to changes in economic and other circumstances which lead to deterioration in the ability of the banks' counterparties to meet their obligations on time.

Given all these different sources of credit risk, it would be necessary for the Board of Directors of Islamic financial institutions to adopt the following measures:[92]

(a) Create an appropriate credit risk culture in the bank by approving and periodically reviewing the strategy of the bank for this purpose and making Senior Management responsible for developing policies and procedures for identifying, measuring,

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90 See, Chapra and Khan, 2000, for a disucssion, Pp.77-83.

91 For a discussion of these see Chapra and Khan, Pp.71-83 and Pp.53-6. See also Khan and Ahmed, 2001.

92 See BCBS, September 2000, for details.

monitoring and controlling credit risk in keeping with the Board's overall goals and strategy.

(b) Establish sound and well-defined credit granting criteria that would help determine the credit-worthiness of the borrower or counterparty; the purpose and structure of the credit, and the source of repayment; his or her repayment history; current capacity to repay; and the terms and conditions on which credit could be granted.

(c) Set proper procedures for amendment, renewal, refinancing and extension of existing credits.

(d) Maintain an appropriate information system that would enable the Management to administer, measure and monitor the credit risk and to develop an internal risk rating system that is in harmony with the nature, size, and complexity of the bank's activities.

(e) Take into consideration potential future changes in economic conditions when assessing individual credits.

(f) Establish a system of independent assessment of the bank's credit risk management process, review this assessment itself, and ensure that Senior Management takes appropriate action to manage problem credits.

Supervisors also have a crucial role to play in credit risk management by banks. They must set prudential limits to restrict bank exposure to single borrowers or groups of connected counterparties as well as to different sectors of business.[93] They must also conduct an independent evaluation of the bank's

[93] A cooperative Islamic bank failed in India when real estate prices collapsed because it had an excessively large exposure to real state.

strategies, policies, procedures and practices related to the granting of credit and the ongoing management of the bank's portfolio.

4.2.2 Liquidity Risk

Liquidity risk arises when there is an unexpected decline in the bank's net cash flow and the bank is unable to raise resources at a reasonable cost in a *Sharī'ah* compatible manner. This would make it difficult for the bank to meet its obligations as they become due, or to fund new opportunities for profitable business.

The mismatch between their deposits and their loans and investments exposes all commercial banks, irrespective of whether they are conventional or Islamic, to liquidity problems. The danger is that the bank may maintain too much liquidity to avoid getting into this difficulty. While a high ratio of liquidity would satisfy the bank's safety consideration, it would hurt its profitability objective. Creating a right balance between the two objectives of safety and profitability is thus the crux of the liquidity management problem.

The liquidity risk faced by Islamic banks seems to be low at present because of the excess liquidity that they generally tend to maintain. [94] Two of the primary reasons for this are: the non-availability of adequate *Sharī'ah*-compatible investment opportunities and the difficulty of raising liquidity in a *Sharī'ah* compatible manner. Nevertheless, a number of factors may lead to liquidity risks in the future. First, most of these banks generally tend to have a larger share of current accounts in their resources than their conventional counterpart (Table 3.5). Second, there is a *fiqhi* restriction on the sale of debts, which constitute a major part of their assets. If they are unable to sell these debts, it may not be possible for them to arrange liquidity when they face a liquidity crunch. Third, due to

94 Iqbal, 2001, P.14.

the slow development of Islamic financial instruments, Islamic banks are not able to raise new funds quickly from the markets. The non-existence of an Islamic inter-bank money market tends to make this problem a little more difficult. Fourth, the Lender of Last Resort (LLR) facility is also not available at present except on the basis of interest. Nevertheless, Islamic banks have so far not faced any serious liquidity problems. This should hopefully continue in the future because the drawbacks indicated above are not insurmountable and will hopefully get resolved in the future as a result of the facilities that are now in the process of being created with the cooperation of banks themselves, the central banks, and the IDB (see sections 6.7 and 6.8).

This takes us to the question of what should the banks do for the effective management of their liquidity? Some measures that need to be considered for adoption are:

(a) The banks should try *not* to depend on a few large depositors. They should rather try to mobilize their deposits from as large a cross-section of depositors as possible. Moreover, they should also try to diversify their sources of deposits in terms of both regions and economic activity. Their success in realizing this goal would depend on their size and sophistication as well as the nature and complexity of their activities. It would be helpful if the Islamic banks are public limited companies with branches in different parts of the country having diversified economic activities.

(b) The maturities of their loans and investments should be staggered in such a way that there is an adequate positive cash flow every day. This would be difficult to realize unless up-to-date cash flow information is available to all concerned departments and there is a coordination between their activities in such a way that maintenance of optimum liquidity is ensured. All information systems should be streamlined for measuring, monitoring, controlling and reporting liquidity. Fortunately, recent

technical and financial innovations have made it possible for banks to do so.

(c) The existence of a deposit insurance system can help greatly in avoiding bank runs resulting from rumours or shocks and thereby minimize sudden deposit withdrawals.

(d) The banks should also have in place a contingency plan to fall back upon in case of liquidity shortage and should also make mutual institutional arrangements to enable them to overcome such a shortage. This is, fortunately, in the process of being done (see section 6.7).

(e) The bank's Liquidity Management Committee should involve all members of Senior Management in monitoring and controlling liquidity. It should also set up an internal controls system to ensure that there is proper coordination and no laxity in the management of liquidity.

4.2.3. Interest-Rate Risk

Interest rate risk is also one of the most serious risks faced by conventional financial institutions. It arises from the exposure of their financial position to adverse movements in interest rates. It is, nevertheless, not possible for them to avoid the taking of this risk because it is a normal part of their business, in the same way as the taking of price risk is a normal part of non-bank business. The crux of business is to buy goods and services at a lower price and to sell them at a higher price.[95] The risk arises from fluctuations in both purchase and sale prices due to reasons over which the business has no control. If the surplus between the two prices is positive in spite of these fluctuations, the business may be able to recover all its expenses and also make a profit, provided that the surplus is adequately large.

Since the price paid and received by conventional banks for their primary job of borrowing and lending is interest, managing interest rate risk effectively is crucially important for increasing their profitability as

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95 Ibn Khaldun, *Muqaddimmah*, P.394.

well as shareholder value. While the taking of interest rate risk is unavoidable for banks, it would not be prudent to let the risk cross a certain limit, because excessive interest rate risk may pose a significant threat to their earning and assets base. Changes in interest rates affect not only their interest-sensitive income and expenses but also the underlying value of their assets, liabilities and off-balance sheet instruments. Accordingly, they are expected to try to develop an effective risk management strategy that would help them maintain the interest rate risk within prudent limits so as to ensure not only the safety and soundness of the bank itself but also the stability of the financial system as a whole.

It may be argued here that, since Islamic banks do not deal in interest, there is no question of their being exposed to the interest rate risk. It would be naive to assume this because Islamic banks operate in a financial environment which is dominated by conventional financial institutions, and interest rate changes are bound to affect their earnings as well as assets value. This is because, in sharp contrast with the PLS modes of financing, all the sales-based modes (*murābahah, ijārah, salam* and *isti ʻʻnāʻ)* involve a mark-up or a pre-determined rate of return and a predominant part of their financing at present consists of these modes. The banks would have been able to minimize the centripetal force of interest-based conventional financial system if a profit-related benchmark for this mark-up were available. Unfortunately, this is not the case and may not be so until the PLS system has captured a substantial share of the financial market in Muslim countries.

In the absence of such a profit-related rate, Islamic banks are constrained to use the London Inter-bank Offer Rate (LIBOR) as a benchmark in their financing operations. This link with LIBOR automatically exposes their income and expenditure flows as well as the value of their assets to the interest rate risk. A rise in LIBOR will lead to a rise in the mark-up and, in turn, to a payment of higher profits to future depositors compared with those received by them from users of their medium- and long-term funds. In addition to affecting their earnings and expenses, changes in interest rates will also change the present value of their future cash flows and thereby affect the present value of their assets, liabilities and balance sheet instruments. The risk becomes a little more magnified in the case of Islamic banks because no agreement has yet been reached among the *fuqahā'* on the permissibility of using

derivatives (futures, forwards, and options) to manage their interest rate and exchange rate risks. It has, therefore, not yet become possible for Islamic banks to design *Sharī'ah* compatible substitutes for the instruments that are used by conventional banks for this purpose.[96]

4.2.4 Operational Risks

There are differences of opinion on the definition of operational risk, which is considered by the BCBS to be a subset of 'other risks'. [97] Other risks have been defined by the BCBS to include all risks other than credit, liquidity and interest rate risks, which have already been discussed above.

These other risks arise from a number of sources. One of the most important of these is the breakdown in internal controls and corporate governance. Such breakdowns can lead to financial losses through error, self-dealing, fraud, or failure to perform an obligation on time in an efficient manner. It may also cause the interest of the bank to be compromised in some other ways, for example, by its dealers, lending officers or other staff exceeding their authority or conducting business in an unethical or highly risky manner. Operational risk arising from the breakdown of internal controls and corporate governance can also lead to shortfalls in the bank's net income or cash flow as compared with that accepted or targeted, and thus create problems for management. Operational risk may also arise from failure of technology, erosion in reputation, or non-compliance with regulatory standards. They may also arise from man-made disasters like fires and accidents or natural disasters like earthquakes and floods.

In addition to these risks, Islamic banks also face substantial *fiqh*-related risks arising from the non-standardized nature of some Islamic banking products. Moreover, an efficient and prompt *Sharī'ah* litigation system is not in place, and banks as well as supervisory staff are not well-oriented in the knowledge of *fiqh*. The *Sharī'ah* supervisors are also not well-versed in the implications of modern risk management concepts. This has had the effect of depriving Islamic banks of some

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96 See Chapra and Khan, 2000; and Khan and Ahmed, 2001, for a more detailed discussion of this subject.

97 See BCBS, December 2001

genuine risk management tools and systems which may not necessarily be in conflict with the *Sharī'ah*. However, some of these difficulties are bound to be resolved with the passage of time with the continued evolution of the system and the resolution of *fiqhi* issues.

In the past, banks relied primarily on internal controls and internal and external audit to manage operational risks. However, recently there has been an emergence of specific structures, tools and processes aimed at managing operational risks. These have made it possible to apply the same kind of rigour to the identification, measurement, monitoring and control of operational risks as is done in the case of credit, liquidity and interest rate risks. It would be necessary to develop an appropriate risk management culture in the bank, make sufficient disclosures to enable the management as well as the depositors and shareholders to assess their operational risk exposure and the quality of the bank's operational risk management. To ensure that banks make a serious effort to manage operational risks, banking supervisors should conduct an independent evaluation of the banks' strategies, policies and procedures to ensure that the banks have an effective system in place to identify, measure, monitor and control operational risks.

4.2.5 Enhancing Risk Management Culture in Islamic Banks

Even though the exposure of most Islamic banks to all these risk factors seem to be relatively high, they have been able to manage them fairly well so far. Nevertheless, this may not necessarily continue in the future. It is therefore extremely important to cultivate an effective risk management culture in these banks to ensure their competitiveness and survival in a world full of uncertainties and crises. This cannot, however, be done without the active collaboration of Senior Management of banks, the *Sharī'ah* scholars, and bank supervisors. For this purpose supervisors must make a number of reports and actions mandatory on the Senior Management of Islamic banks. Some of the most important of these are:

- Development of internal rating systems and the utilization of risk management models,
- Market risk and value at risk (VAR) reports,
- Credit risk reports,
- Liquidity risk reports,

- Operational risk reports, and
- Follow-up on internal control systems with a suitable checklist.

4.3 ENHANCING BANK TRANSPARENCY

Market discipline will be able to play its potential role in improving the functioning of banks and enabling the stakeholders to protect their interest only if all the concerned parties have access to adequate qualitative and quantitative information about the bank's affairs to enable them to make a proper assessment of the bank. Such information will enable depositors to decide whether they should continue to maintain their deposits in the bank and the shareholders to determine whether the time had come for them to sell their shares. It will also help the Board of Directors to know whether the Management is doing its job well, the external auditors to prepare an accurate report on the affairs of the bank, and the supervisors to suggest, before it is too late, corrective measures that would help make the bank safe and sound. Without such information everyone would be in the dark and the Management would be able to sweep all problems under the carpet.

For this reason transparency is extremely important for all market participants. It is even more important in a PLS system where investment depositors would be exposed to the risk of loss, and would, therefore, like to have all the necessary information to enable them to choose for their investments the bank whose performance seems to them to be the best. Accordingly, the BCBS rightly considers transparency to be a key element in an effectively supervised safe and sound banking system.

The Basel Committee defines transparency as the "public disclosure of reliable and timely information that enables users of that information to make an accurate assessment of a bank's financial condition and performance, business activities, risk profile and risk management practices." [98] The Committee, however, warns that disclosure alone need not necessarily result in transparency. Meaningful transparency can be achieved only if every bank provides

[98] BCBS, September 1998, p4.

on a timely basis all relevant information accurately in accordance with set definitions.

This raises the question of what specific information needs to be provided to achieve a satisfactory level of transparency. The Basle Committee emphasizes the provision of accurate and timely information on the following six broad subjects:[99]

a) **Financial performance**: This should indicate the performance of the bank and, in particular, its profits and losses over time. It should also provide breakdowns of income and expenses along with the management's assessment of the quality of earnings, the reasons for changes in profitability from year to year, and the potential for the future;

b) **Financial position:** This is necessary to evaluate the bank's capital, solvency, liquidity and soundness. It should cover information about the nature, amount and breakdown of assets, liabilities, commitments, contingent liabilities and shareholders' funds, both at points in time and averages over periods;

c) **Strategies for management and control of risks**: These constitute a key factor in assessing the future performance and condition of the bank and the effectiveness of its management. Disclosures should throw light on the bank's overall risk management philosophy, policy and methodologies on how risks are undertaken, managed, monitored and controlled and, in particular, the extent to which use is made of risk-mitigating tools like collateral/guarantees, netting agreements, managing concentrations, limits (e.g. credit limits, market risk limits), and derivatives (which and how);

d) **Risk exposures**: This information should provide qualitative and quantitative information about the

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99 *Ibid.,* Pp.17-25.

risks inherent in the bank's on- and off-balance sheet activities, including credit risk, market risk, interest rate risk, foreign exchange risk and liquidity risk, along with the effectiveness of its strategies to manage those risks to ensure that the returns are in step with its risk exposure. This information will help satisfy the user about the bank's financial strength and viability, and the ability to continue the business in times of stress;

e) **Accounting policies:** These should cover general accounting principles and practices, and principles of consolidation; policies and methods for determining and recognizing impairment of assets and the loss of income resulting from these; policies to establish specific and general loan loss provisions; and policies regarding valuation of tangible and intangible assets and liabilities, securitization, foreign currency transactions, income taxes and derivatives;

f) **Basic business management and corporate governance information:** This should disclose information about the basic organizational structure (legal entity), the board of directors (the size, stature and experience of members), and Senior Management structure (qualifications, experience and responsibilities). It should also provide information about the incentive structure of the bank, (including remuneration, performance bonuses, and stock options), and the role of the board of directors in fixing and reviewing the incentive structure.

This raises the question of what happens if Senior Management and the Board provide information that does not reflect the condition of the bank accurately and the bank suffers losses that force it to close down. If the culprits are able to go scot free and also find jobs in other banks, then the imperative of transparency may not have the desired effect on the soundness of banks. In Germany, if the bankers disclose erroneous information or omit to disclose something that is crucial for

knowing the condition of the bank, they will never be able to get a job in the financial industry again.[100] In New Zealand, the punishment is even harsher. Bank owners face unlimited liability.[101] This is not desirable because, while it would be sensible to punish the Directors and the Senior Management, it would be unjust to punish all shareholders.

4.4 LOAN ACCOUNTING AND DISCLOSURE

Experience has shown that the most common cause of bank failures is poor credit quality and ineffective credit risk management. Hence adequate disclosure about credit quality and risk management is necessary to ensure that the banks have attained the kind of transparency that is needed to strengthen market discipline and minimize bank failures.[102] Proper accounting standards which are concerned with the amount of infuriation disclosed, the formats and measurements standards used for this purpose.

This raises the question of what exactly should the information include to provide a clear picture of the bank's condition. The Basel Committee feels that all banks should be required to provide clear and concise information in their annual financial statements on the following four broad areas to give an idea of the bank's state of affairs:[103]

- Accounting polices and practices;
- Credit risk management;
- Credit exposures;
- Credit quality (including information about past due and impaired loans,[104] changes in credit

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100 Caprio and Claessens, 1997, P.32.
101 *Ibid.*
102 . See BCBS, July 1999.
103 BCBS, Best Practices for Credit Risk Disclosure, September 2000.
104 Impaired loans are generally defined as non-performing loans the full payment of which is considered uncertain. Non-performing loans are defined in conventional banking as loans on which principal and interest payments are past due by 90 days

quality during the period, and changes in allowances).

In addition, Islamic banks should also give an evaluation of their PLS assets.

The bank's board of directors has the ultimate oversight responsibility for establishing and maintaining a system of effective internal controls that would, among other things, help ensure that lending transactions are promptly recorded, loan documentation is complete, internal loan review procedures are effective and an appropriate management information system is in place.

To ensure that all this is done, supervisors have an important role to play. They should evaluate the effectiveness of the bank's policies and practices for evaluating the quality of assets and the adequacy of loan loss provisions and reserves to enable the supervisors to obtain a true and fair view of the financial condition of the bank and the profitability of its business. Supervisors should also ensure that the bank publishes on a regular basis financial statements that fairly reflect prudent and realistic measurement of assets, liabilities, equity, derivative contracts, off balance sheet commitments and related profits and losses to enable the users to have a fairly accurate idea of the bank's condition.[105] Capital adequacy requirements provide some cushion against loan losses, but if underlying accounting policies are weak, the resulting capital situation may well be overstated. Accurate and realistic requirement for disclosure of the banks' position would serve as an incentive for the

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or more and the borrower is considered to be in a state of default. In Islamic banking, non-performing loans may be defined as loans that are not paying the principal along with the agreed mark-up in accordance with the original terms of the purchaser's debt agreement in sales-based modes of financing.

105 See principles 8 and 21 of the *Core Principles* (BCBS, 1997).

banks to conduct their operations in a sound and efficient manner.

Since the accounting standards developed for secular business organizations are of limited applicability to Islamic banks,[106] the AAOIFI, which was established in 1991 and is based in Bahrain, has developed standards for Islamic banks. It would be desirable for all Islamic banks to adopt these standards. However, the AAOIFI does not have the authority to implement them. Consensus-building is in progress and it is expected that gradually all Muslim countries will come around to accept them with minor adjustments to suit their special circumstances.

We are glad to report that all banks included in our Survey adhere to international standards of accounting and auditing (Table 1.2) and that their performance with respect to disclosure and transparency requirements also seems to be positive. Our Survey has indicated only 7 percent of the one banks ranked poor in terms of transparency systems while 43 percent had excellent and 36 percent and 14 percent had 'good' and 'fair' systems (Table 2.3). The primary reason for this may be the disclosure and transparency requirements imposed by the regulators in their respective countries.

4.5 *SHARĪ'AH* CLEARANCE AND AUDIT

Among the most crucial responsibilities of an Islamic bank is to create confidence in its depositors as well as all the other operators in the market that its operations are really in harmony with the *Sharī'ah*. For this purpose two important steps need to be taken. The first step is to get a clearance from the *Sharī'ah* Board about the *Sharī'ah* compatibility of all its products. The second step is to provide an assurance that all its transactions are *actually* in conformity with the verdicts of the *Sharī'ah* Board. The first step is like going to a

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106 See Karim, 1999; and Simpson and Willing, 1996.

legal expert to ascertain whether a specific action of the bank is in conformity with the country's laws and, if not, what changes need to be introduced in it to make it so. The second is what auditors and banking supervisors do: to ensure that none of the bank's transactions violates the law.

The *Sharī'ah* Boards are, thus, like legal experts. They can perform the first task. It is difficult for them to perform the second task, which demands a review of all the different transactions that have taken place in different branches of the bank to ensure that they are in conformity with the verdict of the *Sharī'ah* Board. This demands a visit to the bank's premises to examine its operations in the same way as auditors and supervisors do. It is generally assumed that the *Sharī'ah* Boards perform this task. However, members of the *Sharī'ah* Board do not have either the time or the staff to effectively perform such a task. The question that, therefore, arises is: how to ensure the implementation of *Sharī'ah* Board decisions by the bank Management. If this is not ensured the existence of the *Sharī'ah* Board loses its significance. There are three alternatives which may be considered for this purpose.

One of these is for the supervisory authority to itself undertake the *Sharī'ah* audit during the course of its normal supervisory visits. This may not be considered desirable by Islamic banks in countries where the government and supervisory authorities are not favourably inclined towards Islamic banking. It has, however, the advantage that if the supervisory authorities perform the *Sharī'ah* audit they will also try to standardize the *fiqhi* decision. .

The second, but more preferable, alternative is to establish independent *Sharī'ah* audit firms in the private sector. These firms would have to hire and train sufficient staff to examine the transactions of the bank with a view to determine whether they are in conformity

with the *Sharī'ah*. This alternative has the disadvantage that it would involve a proliferation of institutions. Inspectors from three different institutions would knock at the door of the bank at different times. One of these would be from the supervisory authority which sends examiners to banks to determine the conformity of their operations with the country's laws and the principles for safe and sound banking. The other would be the *Sharī'ah* auditors who go to the bank to determine the conformity of its operations with the *Sharī'ah.* The third would be the chartered auditors who would go to ensure that the bank's financial statements have been prepared in conformity with the generally accepted accounting standards. This may not be convenient for banks because it would keep a number of their staff engaged in assisting three inspectors at different times, and thus add to their costs.

A third, and even more preferable, alternative is for the existing chartered audit firms to acquire the necessary expertise in the *Sharī'ah* to enable them to undertake the *Sharī'ah* audit. This will help avoid the proliferation of institutions with which Islamic banks have to deal. The banks would probably prefer this alternative because it will be more convenient for them to have the *Sharī'ah* audit at the same time as the accounts audit. (More on this below in Section 4.6).

4.6 EXTERNAL AUDIT

The growing complexity of the banking business as well as the crises that the international financial system has witnessed have raised the function of external audit to a position of critical importance in all financial systems. It is, however, even more demanding and challenging in the Islamic financial system. It would be necessary for the external auditor to ensure not only that the bank's financial statements are prepared in all material respects in conformity with the professionally accepted financial reporting standards but also that the profit or loss

declared by the bank truly reflects the bank's condition and that its profit has been derived without violating the teachings of the *Sharī'ah.*

It is conventionally not considered to be the task of auditors to perform *Sharī'ah* audit. They are not even equipped at present to do so. However, if this task is assigned to them in the light of what has been discussed above under the subject of *Sharī'ah* audit, then the external auditors will have to create the necessary expertise to perform this task. This would demand that the training of auditors also includes necessary training in the financial aspects of the *Sharī'ah* just as it includes relevant training in auditing and law. If such training proves to be too cumbersome for the auditors, it may also be possible for the auditing firm to hire *Sharī'ah* scholars and provide them some necessary background in auditing.

The external auditor must have professional competence in auditing as well as Islamic banking. He must exercise due care in conducting audit. For this purpose he must have independence and objectivity. The experience of the auditing firm Arthur Anderson has clearly revealed that there should not be anything that would indicate the auditor's vested interest in protecting the bank's management. It is only such impartial auditing that would create confidence in the auditor's report and promote confidence in the bank.

Even though it is the job of the internal controls system to prevent, or detect and correct, material misstatements, arising from fraud and error, the external auditor cannot be exonerated from the responsibility of ensuring that this has been done conscientiously. He will have to design and carry out audit procedures in a way that would help reduce to an acceptably low level the risk of giving an inappropriate audit opinion. The shareholders, the Board of Directors, the Management and the depositors, all depend on his report and it would be a pity if he fails them. The audit report cannot, however, provide an assurance about the future profitability or viability of the bank, or the efficiency and effectiveness with which the Management has conducted its affairs. This would be the job of a consulting firm, and not that of the external auditor, even in an Islamic system.

While it is only the detailed audit of all transactions of the bank that could minimize the risk of not detecting material misstatements, such a detailed audit is not practical because it would be time-consuming and

expensive. The external auditor should, however, follow certain procedures, including inspection, observation, inquiry and confirmation, computation and analysis to fulfil his responsibility. He should be particularly concerned about the recoverability and, consequently, the carrying value of loans, investments and other assets shown in the financial statements. He should also try to ensure the identification and adequate disclosure of all material commitments and liabilities, contingent or otherwise, in the financial statements. The auditor's success in his job would depend greatly on the work of internal auditing. If internal auditing is weak, the external auditor may find it very difficult to do his job effectively. The strength of internal auditor will greatly be influenced by the competence, conscientiousness and integrity of the Board of Directors and Management.

5

THE ROLE OF REGULATION AND SUPERVISION

The presence of built-in incentives and deterrents in a well-functioning competitive financial market can certainly help motivate the Board as well as the Management and the Auditors to perform their tasks well. If this market mechanism gets reinforced by the realization by all market participants of their moral obligation, then some of the shortcomings of the market system can also be substantially reduced. Experience, however, teaches that even the functioning of these two together is usually not sufficient to protect the interests of all stakeholders in an optimum manner? There are market imperfections as well as moral failures. It is also necessary, therefore, for the supervisory authorities to play an important role.

The role that supervisory authorities are expected to play is to ensure that justice is done to all stakeholders. This can be attained through proper regulation and supervision. Regulation and supervision are of greater need in the case of banks because accelerated development cannot be attained without promoting safe and sound banking, protecting the payments system from instability, and ensuring efficient operation of the capital market and its institutions. The leverage of banks is much higher than that of non-bank corporations, and it is, therefore, particularly necessary to prevent mismanagement, fraud, over-lending, credit concentration and exploitation by Management. An efficient legal system enables enforcement of contracts and thereby protects the rights of stakeholders by enabling them to seek redress in courts for damages, provided that the courts are free and fair and are capable of taking impartial

decisions and imposing exemplary penalties on wrong-doers. Regulation and supervision in conformity with the guidelines provided by the BCBS are also necessary to enable the county's banking system to command acceptability in the international financial markets. All the 14 regulatory authorities who responded to our questionnaire have indicated their adoption of the Basel Committee Core Principles as guidelines for rules and regulations in their countries (Table 1.2).

Regulation should not however, be so tight and comprehensive that it raises compliance costs unbearably and also strangulates innovation and creativity. Regulation should also take into account the varying individual needs of banks under changing circumstances and challenges. The trade off between stability and efficiency should not be lost sight of. It would also be desirable to leave a substantial part of the regulatory work to the discretion of the supervisors. This raises the question of how much to stipulate legally and how much to leave to the discretion of supervisors. Regulation should be enough to ensure that:

- the bank is preferably a joint stock company and that all the members of its Board of Directors and Senior Management do not belong to a single family or business group;
- the major shareholders, and members of the Board of Directors and Senior Management do not only enjoy a reputation for integrity and fairness as well as financial strength but also possess the skills and experience necessary to operate an Islamic bank in a safe and sound manner;
- the bank has adequate risk-weighted capital in conformity with the BCBS requirements.
- the bank has appropriate checks and balances, and its internal controls and risk management systems are effective to ensure not only efficient operation but also freedom from fraud, exploitation and misstatement; and

- the bank's non-executive directors and external auditors are independent and do not have a vested interest in supporting the bank's Board or Management.

Regulation would not, however, be meaningful if it is not accompanied by proper monitoring. Effective supervision is, therefore, indispensable. The question that, therefore, arises is about what exactly would banking supervision involve. For supervision to be effective, its objective must be clear and its mechanisms appropriate. The objective has to be to ensure a safe and sound financial system which is not only compatible with Islamic teachings but also internationally recognized and able to compete in the domestic as well as international financial markets. Within an Islamic financial framework, supervision would involve at least two important dimensions: firstly, compliance with the measures specified by the Basel Committee as well as the laws of the country concerned about banking and finance, and, secondly, compliance with the norms of the *Sharī'ah* to give the public the confidence that what they are being provided is not the same product that the conventional system provides, but with a different brand name.

The first step on the ladder of supervision is generally accepted to be the system of licensing which controls entry into the banking system and thereby ensures compliance with prudential regulations. In addition, the supervisory authorities prescribe certain other requirements which tend to vary in keeping with the needs of the economy and the country's value system. Among these are certain ratios to ensure continued adequacy of capital, reserves, cash and liquidity in the bank. There is a difference of opinion about the exact nature of all these requirements. It is, nevertheless, desirable to determine and maintain suitable ratios in a way that would enable the banks to face negative shocks successfully and to protect the depositors from losses. The supervisory authorities also require the periodical submission of financial statements in accordance with set definitions to ensure transparency of all banks in a comparable manner. Such statements are analyzed carefully and, in case of problems, discussions are held with the bank's Management. Guidelines are then given about steps that need to be taken for correction. In the case of Islamic banks, an important requirement is to get clearance from a *Sharī'ah* Board for all new modes of financing to create confidence about their compatibility with the *Sharī'ah.*

The BCBS has also proposed in the *"New Basel Accord"* three complementary pillars for the safety and soundness of the banking system. These pillars are :

- minimum capital requirements in harmony with the risks that the bank faces and, in particular, the credit risk, the market risk and the operational risk;
- supervisory review process which ensures that banks have sufficient capital in keeping with their present and future risk profile, and effective internal controls to inspire confidence in their soundness and solvency;
- market discipline to enhance the role of shareholders and depositors in ensuring that the banks disclose adequate qualitative and quantitative information about their operations, particularly, their capital, reserves, liquidity and risk profile.

Supervisors are also expected to develop mechanisms that would help monitor and limit (and if possible, also measure) a range of banking risks including credit risk, market risk (including interest and exchange rate risk), liquidity and funding risk, operational risk, legal risk and reputational risk, and in particular the risks involved in derivative financial instruments, which would probably be limited in the case of Islamic banks. Experience has shown that the most significant of banking risks is the default of a debtor. This is particularly crucial in the case of Islamic banks. It is, therefore, necessary for the supervisor to assess the quality of the bank's loans and investments. Even though this would be a difficult task, it would, nevertheless, be important to undertake because it is the most critical determinant of the bank's financial condition and ability to survive. For this purpose, the supervisor would have to collect and validate the financial statements and statistical returns submitted by the bank and to carefully review and analyze them. It is this review and analysis which will serve as a basis for discussions with the bank's audit committee, Management and Board of Directors. It is also important for the supervisor to ensure that the bank has in place an effective internal controls system in conformity with the nature and scale of its business and that the quality of its Management is adequate for the nature and scope of its business.

It is now considered extremely important for supervisors to develop and institute a set of indicators of financial soundness to help assess

and monitor the strengths and vulnerabilities of the financial system at both micro and macro levels. At the micro level, indicators should indicate the condition of individual institutions while at the macro level it should help assess and monitor the soundness and vulnerabilities of the financial system as well as the economy. The International Monetary Fund (IMF) has suggested a set of these indicators called macro-prudential indicators which include a core set as well as an encouraged set of financial soundness indicators.[107]

Supervision is, of course, a difficult task. This is because supervision suffers from asymmetric information. The task becomes even more difficult if accounting, auditing and information systems are less developed, as they are in most developing countries. If supervision is difficult, then the role of shareholders becomes extremely crucial for strengthening the safety and soundness of the banking system. Risk-based adequacy of capital also has an important role to play. However, the problem with capital is that, while supervision can ensure its quantity, it cannot ensure its quality. Excessive reliance on capital may not, therefore, be prudent. The addition of investment depositors to the list of monitors may act as an additional buffer. Caprio and Cull emphasize the role of subordinate debt, but the PLS deposits may prove to be a better buffer.[108]

This call for regulation and supervision of Islamic banks is not something new. It was made more than two decades ago by the governors of central banks and monetary authorities of the member countries of the Organization of the Islamic Conference (OIC) in their detailed report on "*Promotion, Regulation and Supervision of Islamic Banks*" approved by them in their Fourth Meeting held in Khartoum on 7-8 March 1981. At that time Islamic banking was in its very initial phase. The first full-fledged Islamic bank, the Dubai Islamic Bank, had been established only six years ago in March 1975. Now that Islamic banking has spread

[107] See Sundararajan, et. al., 2002, for details of these indicators, See in particular pages 3 and 8.

[108] Caprio and Cull, 2000, Pp.v and viii.

and will, *Insha Allah*, continue to spread, regulation and supervision are even more important.

Our Survey of regulators indicates that while the overall regulatory environment for conventional banks in the countries included in our study is relatively good and the variation is relatively less, the regulatory and institutional environment for Islamic banks does not appear to be adequate and the variation is also relatively more (Table 1.2, 1.3 and 1.5). However, our Survey of the Islamic financial institutions indicates that only 28.6 percent of them consider the Islamic regulatory requirements for Islamic banks to be 'excellent' while an equal number consider them to be 'good' and 'fair'. However, 14.3 percent consider them to be 'poor' (Table 2.11), thus implying a substantial room for improvement.

6

SOME SHARED INSTITUTIONS NEEDED FOR EFFECTIVE CORPORATE GOVERNANCE

The moral, social, institutional, legal and supervisory environment that is needed to strengthen corporate governance in Islamic banks has already been discussed above. But this is not sufficient because it reflects only one side of the coin – providing confidence to depositors and shareholders that their interests are protected. Such confidence will lead to the availability of resources to Islamic financial institutions. However, if these institutions do not feel confident about the recovery of their loans from the users along with an optimum rate of return and if no effort is made to solve the problems that they face, they will not be encouraged to make these resources available to the users. This will serve as a serious obstacle to the acceleration of financial as well as economic development in Muslim countries.

The banks will feel confident in providing resources to users if the other side of the coin, pertaining to a solution of the anonymity problem faced by the banks themselves and the difficulties associated with it, does not get the necessary attention. In large urban centres the banks do not know their clients very well and, in particular, the thousands of individuals and businesses who use their funds on a PLS basis. How to make the banks feel confident about the efficient use of their funds and the repayment of these on schedule with an optimum rate of return. Moreover, there is also the problem of recovering on time the funds provided on sales-based modes of financing. Any effort on the part of banks to resolve the problems of anonymity and recovery on their own is bound to be very costly for them.

What is, therefore, needed is the creation of shared institutions that would facilitate this task. These institutions would help the banks in different ways. They would enable them to get reliable information about their clients and to ensure that the funds lent by them to their clients are employed efficiently according to agreement and that the profit declared by them reflects the true picture of the business. They would also help

them receive repayments on schedule, and get justice promptly in case of dispute with, or willful procrastination by, their clients. Banks would also like to have an assurance that they will be able to get liquidity when it is needed by them due to unforeseen circumstances. The creation of such institutions would go a long way in providing the favourable environment that was available to the *´'`arrāfs* in the Classical period. If such shared institutions are not available, then even banks with the best corporate governance may face difficulties and the Islamic financial system may not be able to continue its accelerated growth.

6.1 Credit-Rating Agencies, Chambers of Commerce, and Trade Associations

One of these shared institutions is credit rating agencies which rate banks themselves as well as their counterparties. In the relatively smaller communities of the Classical period, such rating was available informally without the help of any formal organization through the operation of market discipline and the intimate personal contacts of the parties concerned. This was further reinforced by the built-in discipline of the socio-economic structure of tribes, guilds, fraternities and sufi circles. Now it is the credit rating agencies and chambers of commerce and trade associations which can perform this task. Most Muslim countries do not at present have private credit rating agencies. Moreover, the chambers of commerce and trade associations are also perhaps not well equipped to play this role.

The International Islamic Rating Agency (IIRA), which is now in the process of being established in Bahrain, will be a step forward (see Section 6.7). It will perform a number of functions including the rating of all public and private issuers of credit instruments with respect to their financial strength, fiduciary risk, and credit worthiness. It will also assess the compliance with the *Sharī'ah* of financial instruments as well as their issuers. It will have a *Sharī'ah* Board of its own to advise it on *Sharī'ah* issues. It will, thus, complement the work of the AAOIFI in setting standards for adequate disclosure and, thereby, help promote an international capital market for Islamic financial instruments.

Even though the IIRA will rate private non-bank organizations, it will not be possible for it to rate the thousands of counterparties with whom banks deal. It would, therefore, be desirable to have private credit

rating agencies in all Muslim countries to facilitate the task of Islamic banks in choosing their counterparties. In fact the establishment of such institutions would also facilitate the task of the IIRA itself in getting the information that is necessary to know the financial strength, fiduciary risk, and credit worthiness of even those private issuers of financial instruments whose rating the IIRA wishes to provide.

6.2 Centralized *Sharī'ah* Board

It is also necessary to create a centralized *Sharī'ah* Board to clear the *Sharī'*ah compatibility of various modes and instruments of finance used by banks. In the absence of such a centralized board every bank is under an obligation to have its own *Sharī'ah* board. This is very costly, particularly for smaller banks. Moreover, the existence of a large number of *Sharī'ah* boards leads to conflicting opinions which creates inconsistency and uncertainty. With the passage of time and the free discussion of all controversial issues, the conflicts would tend to get gradually resolved. However, in the initial evolutionary phase such a centralized board seems to be necessary to minimize the conflict and to standardize the instruments of Islamic finance. Such standardization will pave the way for the creation of an Islamic financial market (see Section 6.7). Seven countries (50 percent of our sample) have already standardized their instruments (Table 1.4). It is desirable that other Muslim countries do the same. It is also necessary that the standardization takes place even at the level of all Muslim countries. The Islamic *Sharī'ah* Board proposed to be established by the IIRA may be able to complement and accelerate the work of the OIC *Fiqh* Committee in the pursuit of this goal.

6.3 Chartered *Sharī'ah* Auditors

It is also necessary to create, as discussed earlier, chartered *Sharī'ah* auditors or to train chartered accountants in the task of *Sharī'ah* audit. A certificate from the *Sharī'ah* Board based on such audit will help create confidence in the public that the operations of the banks are really in harmony with the *Sharī'ah*.

6.4 *Sharī'ah* Courts or Banking Tribunals

Another indispensable need of the Islamic financial system is availability of some judicial facility that would help the banks recover their loans promptly from clients who are unjustifiably procrastinating repayment and also help bank clients get prompt justice at a low cost when the bank is acting unjustly. The establishment of *Sharī'ah* courts or banking tribunals would be very helpful in getting prompt verdicts on the disputes of banks with their clients and vice versa. Normal civil court verdicts usually take several years. The *Sharī'ah* courts or banking tribunals would have a greater deterrent effect if the names of banks or their client whom these courts have found to be guilty are also published in newspapers. The fear of getting bad publicity would help minimize contractual violations. Furthermore, the names of parties who violate habitually may also be sent to the chambers of commerce and trade associations for blacklisting to create the same effect that social ostracization had in the Classical period.

6.5 Audit Organization

It may also be desirable to have an audit organization jointly owned by banks to evaluate the profit-and-loss accounts of those of their clients who the banks feel have tried to cheat them in a PLS arrangement. The fear of being exposed to a thorough check of their accounts by such an organization would complement the market forces in helping minimize the effort by users of funds on a PLS basis to shortchange the banks.

6.6 Training in Islamic Banking

It is also necessary to train the staff and clients of banks as well as the general public in the principles of Islamic banking. This is now done by the banks themselves and adds to their costs. If the central banks as well as schools and universities could make arrangements for this purpose, as is done in the case of conventional banking, the task of Islamic banks would become relatively easier.

6.7 Islamic Financial Market

It is also necessary to create an Islamic financial market. The absence of a secondary market for Islamic financial instruments makes it extremely difficult for Islamic banks to manage their liquidity.

Consequently, they end up maintaining a relatively higher ratio of liquidity than what is generally done by conventional banks. This affects their profitability and competitiveness. Therefore, the decision to establish three institutions called the IFSB, the International Islamic Financial Market (IIFM), and the Liquidity Management Centre (LMC) is highly commendable.

The IFSB will promote uniform regulatory and supervisory practices and prudential standards for Islamic financial institutions in the same way as is done by the BCBS. The availability of uniform standards will make the task of regulators and supervisors in Muslim countries easier because they will have some readily available standards and core principles for regulation and supervision in conformity with the *Sharī‘ah*. They could then make adjustments in these according to their own special needs and circumstances. The IFSB will also serve as a liaison for, and promote cooperation with, other standard setters. It will also promote good practices in risk management.

The IIFM will try to fulfil the need for a viable alternative to the conventional financial market. It will enhance cooperation in the field of finance among Muslim countries and financial institutions by promoting product development and harmonizing trading practices. This will serve as a catalyst for the development and promotion of a larger supply of *Sharī‘ah*-compatible financial instruments.

The LMC will serve as an operating arm of the IIFM in the effort to facilitate the creation of an inter-bank money market that will enable Islamic financial institutions to effectively manage their assets and liabilities. It will create short-term *Sharī‘ah*-compatible investment opportunities by providing liquid, tradable, asset-backed treasury instruments (*´'`ukūks)* in which these institutions can invest their surplus liquidity. It will also facilitate the sourcing and securitization of assets and actively trade in *´'`ukūks* by offering buy/sell quotes.

The establishment of these three institutions will together help remove the drawback experienced by Islamic banks as a result of the lack of standardization of terms and instruments and the non-availability of quality *Sharī‘ah*-compatible assets for trading in the secondary markets. It is consequently expected that the Islamic financial system may be able to expand at a faster rate in the future and thus create for itself a larger niche in the financial markets of Muslim countries.

6.8 Lender of Last Resort

Islamic banks also need some facility akin to the lender-of-last resort which is available to conventional banks to overcome liquidity crises when they occur suddenly due to unforeseen circumstances. Such a facility is available to Islamic banks at present on the basis of interest and is, therefore, unacceptable because of its incompatibility with the *Sharī'ah.* Its use exposes Islamic banks to a great deal of criticism. It may be worth considering the creation of a common pool at the central banks to provide mutual accommodation to banks in case of need. All banks may be required to contribute a certain mutually agreed percent of their deposits to this common pool, just as they do in the case of statutory reserve requirements. They would then have the right to borrow interest-free from this pool with the condition that the net use of this facility is zero (i.e. drawings do not exceed contributions) over a given period of time.[109] In a crisis situation the central banks may allow a bank to exceed the limit, with appropriate penalties, warning, and a suitable corrective programme. This will in a way be a more organized way of replacing the framework for mutual cooperation that prevailed among the *sarrāfs* during the Classical period.

6.9 Reform of the Stock Market

Reform of the stock market is also necessary in the light of Islamic teachings to ensure that share prices reflect underlying business conditions and do not fluctuate erratically as a result of speculative forces. The discipline that the *Sharī'ah* helps introduce in the financial market will certainly be of great help.[110] In addition rules and procedures need to be formulated and enforced to protect investors and to maintain the integrity of the stock market. A well-organized and properly regulated

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109 Some of the *fuqahā'* may not find this to be acceptable because it may appear to them as a form of reciprocal lending *(qurūd mutabādalah)* which to them is like deriving benefit from a loan, and hence equivalent to interest. However, it can also be looked at as a form of cooperative insurance, whereby the banks provide themselves with protection in case of need and the central bank does not get any return for its management of the fund. Mutual cooperation of this nature had prevailed in Muslim history between businesses in the form of what was then called *ib▯ā‘ or bi▯ā‘ ah.* (See Chapra, 1985, Pp.75 and 250).

110 See Chapra, 2000, in Iqbal and Lewellyn, 2000.

stock market should help provide the ‘sane’ secondary market that is necessary to raise the confidence of savers and investors in the system and to enable them to buy or sell shares in response to their circumstances or their perceptions of future market developments. Such a reform would constitute one of the most important pillars for supporting the edifice of an interest-free and equity-based economy.[111]

[111] The detailed discussion that this subject requires is beyond the scope of this paper. For some relevant discussion on the reform of the stock market, see Chapra, 1985, Pp.95-100; and Chapra, 2002

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CONCLUSION

Islamic banks have made commendable progress over the last two to three decades. They are, nevertheless, relatively very small in terms of their assets and capital, and have not been able to create for themselves a large enough niche in the fields of domestic as well as international finance. It is, therefore, necessary to take all measures that would help promote their expansion.

This brings into focus the measures that need to be taken. Some of these are: creation of an enabling environment by strengthening market discipline in the financial sector, moral integrity on the part of financial institutions as well as users of funds, an appropriate socio-political environment with equitably enforced legal and institutional checks to ensure fulfillment of contracts and promises. What is also needed is effective corporate governance and shared institutions to enable the system to replace the environment that existed in the Classical period.

Corporate governance has gained great promise over the last two decades even in the conventional financial system because of continued financial instability. It is of even greater importance in the Islamic system because of the additional risk to which the depositors get exposed as a result of risk-sharing. It is, therefore, important to give due attention to all crucial aspects of corporate governance some of which, as our empirical Survey has revealed, are weak in Muslim countries. It is important to make the Board of Directors and Senior Management more effective in the performance of their responsibilities. Making them truly accountable before shareholders and depositors by the adoption of measures discussed in the paper will greatly help in the realization of this goal.

It is also important to sharpen the tools of corporate governance. The most important of these are: internal controls, risk management, transparency, loan accounting and disclosure, *Sharī'ah* clearance and audit, external audit, and prudential regulation and supervision. Total reliance on these would, however, not be sufficient. Moral commitment

on the part of all market operators is indispensable. Without such commitment, market operators will find different ways of violating the law without getting detected and punished. This will create a need for more and more legal checks and controls, which will raise transactions costs to an unbearably high level. What is also needed is the establishment of a number of shared institutions without which even banks with the best corporate governance may not be able to avoid crises.

Muslim countries, therefore, face a challenge and there is no reason to believe that this challenge cannot be met successfully if there is co-operation between Islamic banks, the regulatory authorities, and the *fuqahā'*. Consensus-building may be expedited if all of them, join their hands and play a more concerted role in the development and expansion of the Islamic financial system.

Since all this is time-consuming, we need to bear in mind that full-fledged elimination of interest from Muslim countries will take place only gradually after going through an evolutionary process. There should be no qualms about this because the Prophet's own example clearly demonstrates a preference for gradual implementation. However, the preference for a gradual approach should not be considered as a license for doing nothing or moving at a snail's pace. Islamic banking can make a valuable contribution not only to Muslim countries but also to the international financial system, which is plagued by continuing crises and instability. It deserves all the help that it needs.

APPENDIX 1

A Survey of Corporate Governance in Islamic Financial Institutions

Part 1: Results of the Survey

This Appendix reports the results from a Survey on different aspects of corporate governance in Islamic financial institutions. There have been a number of empirical studies of corporate governance in conventional banks. However, most of these address some specific issue on the subject. For example, La Porta, et. al.,[112] show that common law countries generally best protect investors, while civil law countries provide relatively weak legal protection. Similarly, empirical results of Levine, et. al.,[113] indicate that countries which ensure legal rights to creditors tend to have better developed financial intermediaries. Furthermore, legal systems that rigorously enforce contracts, and accounting standards that produce high-quality, comprehensive, and comparable corporate financial statements, tend to have better developed financial intermediaries. Alvarez, et. al.,[114] show a non-linear relationship between board size and board effectiveness. As the board size increases, there is initially an improvement in board performance. However, increase in the board size beyond an optimum level reduces the performance of the board.

Studies on corporate governance in Islamic banks are scant and, like those on conventional banks, focus attention on specific issues. While some address the accounting and auditing aspects of the subject,[115] others try to determine the banks' overall strategies and investment policies as well as the role of *Sharī'ah* supervisory boards in the operation of Islamic banks,[116] or compare the behavior of depositors of Islamic banks with that of conventional banks in Jordan.[117] Compared with these studies, ours is a comprehensive survey. Its objective was to identify the environment within which Islamic financial institutions operate as well as the major aspects of their corporate governance from the perspective of different stakeholders.

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112 LLSV, 1999a.
113 Levine, et. al., 1999, P.31.
114 Alvarez, et. al., 1981.
115 Gambling and Karim, 1991; Karim, 1990; Banaja, et. al., 1994; Archer and Abid, 1996; Baydoun and Willet, 1997; Hood and Bucheery, 1999.
116 Lewis and Algaoud, 2001.
117 Erol, et. al., 1990.

The Survey was based on questionnaires sent by mail as well as field level interviews. It was conducted at three levels. At the first level were the regulators. Questionnaires were sent to 30 central banks of OIC member countries by mail and a total of 14 central banks responded to these questionnaires. This was reinforced by the personal interview of officials of central banks in three countries (Bahrain, Bangladesh and Sudan) by a researcher. At the second level were the financial institutions. Questionnaires were mailed to 60 financial institutions in 26 countries specified above. A total of 14 completed questionnaires from six countries was included in the study. In addition, a researcher met officials of 12 Islamic banks in the three countries

At the third level, depositors of Islamic banks were interviewed in three countries to determine their role as stakeholders and their views on the governance of Islamic banks. Three criteria were used for the selection of these countries. First, they should have several Islamic banks in operation. Second, they should provide a balanced geographical representation. Accordingly, one country was chosen from South Asia (Bangladesh), one from the Gulf region (Bahrain), and one from Africa (Sudan). Finally, the variations in regulatory regimes were also considered to be an important factor in the selection. While Sudan has an Islamic financial system and Bahrain has a regulatory framework for both conventional and Islamic financial institutions, Islamic banks in Bangladesh operate under a conventional regulatory environment. A total of 165 questionnaires were completed for depositors in Bangladesh, 153 in Bahrain, and 150 in Sudan. The results from the Survey at these three levels are discussed below.

1. Regulators

The 14 regulatory authorities/agencies that responded to our questionnaire are listed in Table 1.1. As the economies of countries included in this study vary, it is expected that the regulatory regimes will be different. The information collected from regulators falls under three categories: viz., the overall regulatory environment, the regulatory regime for Islamic banks, and the perception of regulators regarding the risks faced by Islamic banks vis-à-vis their conventional counterparts. Results on each of these categories are discussed below.

Table 1.1: List of Countries included in the Study

Country	Name of the Agency/Institution
Algeria	Banque D'Algerie
Azerbaijan	National Bank of the Azerbaijan Republic
Bahrain	Bahrain Monetary Agency
Bangladesh	Bangladesh bank
Indonesia	Bank Indonesia
Jordan	Central Bank of Jordan
Kuwait	Central Bank of Kuwait
Kyrgyz Republic	National Bank of the Kyrgyz Republic
Malaysia	Bank Negara Malaysia
Qatar	Qatar Central Bank
Saudi Arabia	Saudi Arabian Monetary Agency
Sudan	Bank of Sudan
Turkey	Banking Regulation and Supervision Agency
U.A.E.	Central Bank of U.A.E.

1.1 Overall Regulatory Environment

The overall regulatory regime identifies the general rules and regulations for financial institutions in an economy. These rules apply to all financial institutions and try to ensure the stability and soundness of the financial system. Regulatory rules and guidelines include issues like developing internal controls, formulating corporate governance procedures, and setting standards of transparency. There were 10 questions to ascertain the overall regulatory environment (see Table 1.2). The question had affirmative/negative answers. We report only those answers that were marked affirmative implying that the remaining answers were either marked negative or left unanswered. Larger numbers (closer to 10) would imply good overall regulatory environment.

Results on regulatory environment are reported in two ways. First, the results are reported across countries by adding the number of affirmative answers to each question. These results, reported in Table

1.2, show the number (and the percentage) of countries in the sample that have adopted or applied the feature asked in the question. Second, we added the affirmative answers by individual countries to have an indication of their overall regulatory regime. The results are summarized in Table 1.3.

Table 1.2: Overall Regulatory Environment: General Rules and Regulations Across Countries

	No. of Affirmative Responses	Percentage of Total
1. Are Basel Committee Core Principles recommendations adopted as the guidelines for rules and regulations in the country?	14	100
2. Does the regulatory organ require financial institutions to get ratings from international rating agencies?	0	0
Is there any institutional setup for deposit protection or insurance?	7	50
4. Can financial institutions engage in multiple activities (banking, trading, insurance, etc.)?	5	35.7
5. Does the central bank or any other agency in the country develop standards and risk management procedures for banks and financial institutions?	14	100
6. Does the regulatory agency require risk-based capital requirements for banks and financial institutions?	14	100
7. Are international standards of accounting and auditing adhered to in financial institutions as a matter of routine?	13	92.8
8. Are there any standards for corporate governance set for financial institutions?	12	85.7
9. Are financial institutions required to provide any guidelines of their corporate governance structures and practices?	10	71.4
10. Are the financial institutions required to submit standardized reports to the regulators regularly?	14	100
TOTAL	103	73.6

Table 1.2 shows that all the regulatory authorities/agencies that responded (14) to our questionnaire have adopted the Basel Committee Core principles as guidelines for rules and regulations in the country.

None of the regulatory authorities in the sample, however, requires financial institutions to get ratings from international rating agencies. Only 50 percent (or 7 countries) have an institutional setup that protects depositors and 5 regulatory authorities (35.7 percent) permit financial institutions to engage in multiple activities. All countries in the sample (100 percent) develop standards and procedures for risk management and make the risk-based capital requirements for banks and financial institutions. Thirteen central banks (92.8 percent) report that financial institutions adhere to international accounting and auditing standards. While in 12 cases (85.7 percent) the regulatory authorities report that they set corporate governance standards for financial institutions, only 10 cases (71.4 percent) require the financial institutions to provide guidelines for their corporate governance structure and practices. Finally in all cases (100 percent), regulators require financial institutions to submit regularly their standardized reports.

Table 1.3: Overall Regulatory Environment: Summary of General Rules and Regulations for Individual Countries

Total Questions	10
Average of Affirmative Answers	7.4
Maximum Affirmative Answers	9
Minimum Affirmative Answers	6
Standard Deviation	0.93

In Table 1.3, we summarize the results of the regulatory regimes found in the countries of the sample. We observe that the average number of affirmative questions is 7.4, with a maximum of 9 and a minimum of 6. A small standard deviation of 0.93 shows that the dispersion in the regulatory regimes in the sample is relatively small.

1.2 Regulatory Regime for Islamic Banks

This section identifies the nature of Islamic regulatory regimes in the countries of the sample. There are 10 factors which are considered to determine the nature of regulatory regime for Islamic banks. These include the legal system, rules and regulations, standards and guidelines, and supporting departments and agencies that facilitate the operations of Islamic banks. These questions indicate whether the

countries have laws, regulations and institutions that are supportive of Islamic financial institutions. As the case of Overall Regulatory Environment (discussed in Section 1.1 above), we present the results in two ways. First, the results are presented across countries by adding the affirmative answers to each of the questions to get a general view of the Islamic regulatory regime in the countries studied. Second, we summarize the results for countries to get an idea of the state of regulatory regime for Islamic banks of the sample countries.

Table 1.4 shows the results of the regulatory regime for Islamic banks across countries. Nine countries (or 64.3 percent) in the sample have a law that provides for Islamic banking and 8 countries (57.1 percent) have separate rules and regulations that apply to Islamic financial institutions. At the regulatory level, only 5 countries (35.7 percent) have a separate department/office that deals with Islamic banks. Regulators from 8 countries (57.1 percent) indicate that standards and risk management procedures for Islamic financial institutions have been developed. While 4 countries (28.6 percent) have discount window facility for Islamic financial institutions, only 3 countries (21.4 percent) indicate they require Islamic financial institutions to adhere to AAOIFI standards of accounting and auditing and have *Sharī'ah* Supervisory Committee/Board at the regulatory level. The Survey further shows that 8 countries (57.1 percent) have access to legal facilities for settling disputes relating to Islamic banks. Ten regulators (71.4 percent) indicate that there is a general awareness of the risks relating to Islamic banks and in 7 countries (50 percent) the Islamic financial products are standardized.

Table 1.4: Regulatory Regime for Islamic Banks Across Countries

	No. of	Percentage

	Affirmative Responses	of Total
1. Does any existing law have any provision for Islamic banking and financial institutions?	9	64.3
Are there separate set of rules and regulations governing Islamic financial institutions?	8	57.1
3. Is there a separate department/office in the central bank that deals with Islamic banks?	5	35.7
4. Does the central bank or any other agency in the country develop standards and risk management procedures particular for Islamic financial institutions?	8	57.1
5. Does the central bank have special discount windows facilities for Islamic financial institutions?	4	28.6
6. Are Islamic financial institutions required to adhere to AAOIFI[a] standards of accounting and auditing?	3	21.4
7. Is there access to redress legal matters for settling disputes relating to Islamic banks?	8	57.1
8. Do you think there is a general awareness of the risks faced by Islamic banks?	10	71.4
9. Is there any *Shari'ah* Supervisory Committee/Board at the regulatory level?	3	21.4
10. Are Islamic financial products/instruments standardized in your jurisdiction?	7	50.0
TOTAL	65	46.4

a) -Accounting and Auditing Organization for Islamic Financial Institutions, Bahrain

Table 1.5: Summary of Regulatory Regime for Islamic Banks in Individual Countries

Total Number of Respondents	14
Total Questions	10
Average of Affirmative Answers	4.6
Maximum Affirmative Answers	10
Minimum Affirmative Answers	0
Standard Deviation	3.15

Table 1.5 summarizes the results of the regulatory regimes for Islamic banks in individual countries. The average number of affirmative responses to the 10 questions asked is 4.6 only, with a maximum of 10 and minimum of 0. We observe that the standard deviation is 3.15 indicating that there is relatively widespread dispersion and variety in the regulatory regimes for Islamic banks of the sample countries.

1.3 Islamic Banks Vs. Conventional Banks

In this section, we report the views of regulatory authorities regarding different aspects of Islamic banks relative to their conventional counterparts that may have regulatory implications. The financial sector is prone to systemic risks that can spread instability in the whole financial system and the economy. In this regard, setting up rules and standards by regulators are crucial for the development and stability of the financial system. The perception of the regulators regarding different risks that Islamic banks face vis-à-vis conventional banks will determine whether or not Islamic banks should be treated differently. Table 1.6 shows the perceptions of regulators regarding the different aspects that may have regulatory implications. Note that the numbers given for each question do not add up to 14 (the total number of countries in the sample) as some regulatory authorities/agencies did not respond.

Table 1.6 shows that 8 regulators (57.1 percent) think that there are no differences between Islamic banks and conventional banks with regard to systemic risk and the institutional ability to create market discipline. The same percentage (57.1 percent) of respondents thinks that the depositors of both Islamic and conventional banks have similar protection and have the same likelihood to be cheated. While 3 respondents (21.4 percent) believe that Islamic banks are more prone to

systemic risk and create more market discipline than conventional banks, 1 regulator (7.1 percent) thinks that they are less prone to systemic risk and create less market discipline than their conventional counterparts. The figures are reversed when it comes to protection of the depositors and the institutional risk to be cheated (prone to fraud). While 1 regulator (7.1 percent) thinks depositors in Islamic banks are more protected and prone to fraud, 3 of them (21.4 percent) believe that they are less protected and less prone to fraud.

Table 1.6: Islamic Vs Conventional Banks

	More	Same	Less
1. Compared to Conventional banks, are Islamic banks more/less prone to systemic risk?	3 (21.4%)	8 (57.1%)	1 (7.1%)
2. Compared to conventional banks, are depositors of Islamic banks more/less protected?	1 (7.1%)	8 (57.1%)	3 (21.4%)
3. Compared to conventional banks, do you think Islamic banks should have more/less capital requirements?	3 (21.4%)	9 (64.3%)	0
4. Compared to conventional banks, do you think Islamic banks are more/less prone to fraud?	1 (7.1%)	8 (57.1%)	3 (21.4%)
5. In contracting, does an Islamic financial contract have the same set of rights which one expects to be conferred if the transaction took place in the conventional contract.	2 (14.3%)	8 (57.1%)	0
6. Compared to conventional banks, do you think that the accounting and auditing standards of Islamic financial institutions are more/less difficult?	5 (35.7%)	7 (50%)	0
Compared to conventional banks, the risks of withdrawal faced by Islamic banks on their investment (*muḍārabah*) accounts are more/less?	4 (28.6%)	6 (42.9%)	2 (14.3%)
8. Compared to Conventional banks, do you think that the Islamic banks create more/less market discipline?	3 (21.4%)	8 (57.1%)	1 (7.1%)
9. Should the loan loss reserves required by Islamic Banks be more/less than conventional banks?	1 (7.1%)	9 (64.3%)	2 (14.3%)

Nine regulators (64.3 percent) are of the opinion that Islamic banks should have the same capital requirements as conventional banks. Three regulators (21.4 percent), however, responded that capital requirements for Islamic banks should be higher than those for their conventional counterparts. Similarly, while 8 respondents (57.1 percent) think that the rights conferred in an Islamic financial contract are the same as those in a conventional contract, 2 regulators (14.3 percent) indicate that Islamic contracts have more rights. Regulators from 7 countries (50 percent) consider accounting and auditing standards of Islamic financial institutions to have similar level of difficulty as that in conventional banks and 5 of them consider the standards to be more difficult for Islamic financial institutions. As regards the risk of withdrawal of investment accounts, 4 regulators (28.6 percent) think Islamic banks face higher risks, 2 (14.3 percent) think that they face lower risk, and 6 (or 42.9 percent) think that they have similar risks of withdrawal compared to their conventional counterparts. Finally, while 9 respondents (64.3 percent) think that loan loss reserves for Islamic banks and conventional banks should be the same, 1 regulator (7.1 percent) thinks that they should be more for Islamic banks, and 2 of them (14.3 percent) think that they should be less. When we add the total responses to each category of answers in Table 1.6, we see that a total of 71 responses (56.4 percent of the total) indicate that the various risk aspects of Islamic banks are similar to those of conventional banks.

2. Islamic Financial Institutions

In this section we examine issues related to corporate governance from the perspective of Islamic financial institutions. As mentioned above, questionnaires were mailed to 60 Islamic banks in 26 countries. A researcher visited 12 financial institutions in Bahrain, Bangladesh, and Sudan. A total of 14 completed questionnaires from Islamic financial institutions of 6 countries are included in the study. The financial institutions included in the study, along with the countries they operate in, their legal status and activities are listed in Table 2.1. We notice with respect to the legal status of financial institutions included in our sample that 10 are public limited companies, 2 are private limited companies, and 2 are joint stock companies (one exempt and the other one public). We observe that most of the banks indicate that they have more than one activity. Only 5 financial institutions report that they are commercial banks, while the rest have multiple activities.

Before discussing the status of specific corporate governance issues of Islamic financial institutions, we examine the relative size of

Islamic banks by reporting their basic balance sheet data. Table 2.2 shows that the average value of assets of 14 banks included in the study is US$ 412.2 million, with the largest institution having US$ 1.64 billion in assets and the smallest having only US$ 28.2 million. A relatively large standard deviation (of 493.6) shows that there is wide dispersion in the financial institutions included in the study. Similar features are observed with the liabilities of the banks. While the maximum amount of liability is US$ 1.32 billion and the minimum is US$ 11.7 million, the average value is US$ 338.7 million. Again there is a wide dispersion on the liabilities side as seen by a relatively large standard deviation (408.1). The average capital of banks in the study is US$ 74.4 million giving an average capital to assets ratio of around 18 percent. There is a wide variation in the capital of the financial institutions with the smallest bank having capital of US$ 5 million and the largest US$ 348.7 million.

Table 2.1. List of Islamic Banks Included in the Study

Name	Country	Legal Status	Activity Type
ABC Islamic Bank	Bahrain	Exempt Joint Stock Co.	Offshore & Investment
Abu Dhabi Islamic Bank	U.A.E.	Public Joint Stock Co.	Commercial, Investment, & Retail
Al Arafah Islamic Bank	Bangladesh	Public Limited Co.	Commercial
Al Baraka Islamic Bank	Bahrain	Private Limited Co.	Commercial, Offshore & Investment
Badr Forte Bank	Russia	Private Limited Co.	Commercial, Investment & Stock Brokers
Bahrain Islamic Bank	Bahrain	Public Limited Co.	Commercial and Investment
Bangladesh Islamic Bank	Bangladesh	Public Limited Co.	Commercial
Faisal Islamic Bank	Sudan	Public Limited Co.	Commercial
Gulf Investment House	Kuwait	Public Limited Co.	Investment
Omdurman National Bank	Sudan	Public Limited Co.	Commercial & Investment
Shamil Bank	Bahrain	Public Limited Co.	Commercial, Offshore & Investment
Social Investment Bank	Bangladesh	Public Limited Co.	Commercial
Sudanese French Bank	Sudan	Public Limited Co.	Commercial
Tadamon Islamic Bank	Sudan	Public Limited Co.	Commercial & Investment

Table 2.2. Basic Balance Sheet Data

	Assets	Liabilities	Capital
Number of Observations	14	14	14
Average (Million US$)	412.2	338.7	74.4
Maximum (Million US$)	1,644.6	1315.8	348.7
Minimum (Million US$)	28.2	11.7	5.0
Standard Deviation	493.6	408.1	101.98

Table 2.3 shows the ownership structure and concentration of shares in the financial institutions. The table shows that the ownership structure varies in the sample. One financial institution (ABC Islamic Bank) is a wholly owned (100 percent) subsidiary of another institution. As the inclusion of this bank will bias the results, we exclude this from Table 2.3. The data on other financial institutions shows variation in the ownership structure. While an average percentage ownership of 25.2 percent for the single largest shareholder, the single largest shareholder of an Islamic bank in the sample owns 60 percent of the shares and the smallest single shareholder owns only 3.7 percent.

Table 2.3. Ownership Concentration in Islamic Banks

	Shares held by		
	Largest Single Shareholder	Largest Five Shareholders	Largest Ten Shareholders
Number of Observations	13[a]	13	13
Average (Percentage)	25.2	51.7	62.5
Maximum (Percentage)	60.0	91.7	99.0
Minimum (Percentage)	3.7	14.7	25.8
Standard Deviation	25.2	24.8	23.8

i- ABC Islamic Bank is a wholly owned subsidiary (100 percent) of ABC Bank is excluded in this table

The largest five shareholders in the sample on the average hold more than half of the total shares (51.7 percent). The maximum percentage for the largest 5 shareholders is 91.7 percent, while the corresponding figure for the minimum is 14.7 percent. The average

share of the 10 largest shareholders in the sample is 62.5 percent. The shares of the 10 largest shareholders take the value of 99.0 percent to the maximum and 25.8 percent to the minimum. These figures along with value of the relatively high standard deviations imply that the ownership of Islamic financial institutions in the sample varies. The figures in Table 2.3 show that on the average, the largest five shareholders hold a majority stake (51.7 percent) in these institutions. This high average indicates that ownership in Islamic banks is relatively concentrated.

Table 2.4 reports some characteristics of the Board of Directors of the banks in the study. While at one extreme, a bank has 27 members in its board and at the other extreme it has 4 board members, the average size of the board in the Islamic banks is around 12. On an average, two members from the management are on the board (as executive board members). However, this number varies from a low of zero to a high of seven. Table 2.4 also shows that there is great variation in the shares held by board members. The board members hold a maximum of 90 percent of the shares and a minimum of 0.3 percent. The average share held by the board members in our sample is 29.1 with a standard deviation of 28.8. While the data on the characteristics of the board show variation, the average share held by board members appears to be relatively high. This may be due to the fact that ownership is concentrated as we had seen in Table 2.2 above.

Table 2.4. Structure of Board in Islamic Financial Institutions

	No. of Board Members	No. of Executive Board Members	Percentage Share held by Board Members
Average	12.2	2.3	29.1
Maximum	27	7.0	90.0[a]
Minimum	4	0	0.3
Standard Deviation	7.7	2.9	28.8

i- Excludes ABC Islamic Bank

Table 2.5. Committees for Improving Corporate Governance

	Number	Percentage of Total
Executive Committee	10	71.4
Risk Management Committee	5	35.7
Audit Committee	9	64.3
Compensation /Remuneration Committee	3	21.4
Nomination (of Board) Committee	1	7.1
Corporate Governance Committee	2	14.3

Corporate governance in firms can be improved if different committees that supervise various aspects of governance are established. Table 2.5 shows the different committees that Islamic financial institutions in the sample have. We observe that 10 banks (71.4 percent) have executive committees that are responsible for overall management of the institution. Half that number (35.7 percent) have risk management committees and nine (64.3 percent) have audit committees. While three institutions (21.4 percent) have compensation or remuneration committee, only 1 of them (7.1 percent) has nomination committee for board members and 2 (14.3 percent) report to have corporate governance committees.

Having discussed the ownership and organizational structure of banks in our sample, we now discuss the status of various aspects or elements of corporate governance for the Islamic financial institutions. The questions related to corporate governance issues in the questionnaire can be broadly classified into two categories. First, there are questions that can be classified as internal factors that relate to the organization and operations of a financial institution. The second group of questions relates to the external environment under which the banks operate. While the financial institutions have control over the internal factors, the external environment is beyond their control. Note, however, that the external environment has an indirect impact on the internal factors. For example, while we will discuss issues like shareholder rights and disclosure and transparency under internal factors, these may be determined to a large extent by the company law/act and regulations.

We discuss next different aspects of corporate governance under these broad categories.

2.1. Internal Factors

The issues that determine the status of corporate governance in Islamic financial institutions relating to internal factors are classified into five major aspects or elements. These are rights and equitable treatment of the shareholders, and of other stakeholders, responsibilities of the board, disclosure and transparency, and management of the banks' operations. There were several questions in each of these aspects (please see the questionnaire for details). The possible answers to these questions are four: 1). Fully (or always) Observed (FO); 2) Largely (or usually) observed (LO); 3). Materially not (or sometimes) observed (MNO); and 4). Not (or never) observed (NO). To arrive at the summarized results reported in the tables for each aspect or element of corporate governance, we followed the following steps.

a) The following scores were given to each of the answers: FO =3, LO=2, MNO=1, and NO = 0.
b) The scores of different answers for the aspect were then added for each financial institution. Assume *y* is the score that an institution gets against a total possible of *z* (=number of questions × 3)
c) To compare across different aspects, we convert the scores into percentages *Y* (=*y/z* ×100).
d) To rank the status of corporate governance aspect for each financial institution, the following guideline were used:
    - Percentage Scores between 90-100 = *Excellent*;
    - Percentage Scores between 80-90 = *Good;*
    - Percentage Scores between 70-80 = *Fair*; and
    - Percentage Scores below 70 = *Poor*.
e) The results in tables show the distribution of different financial institutions according to these ranks for each of the aspects or elements of corporate governance.

The results for the status of different elements of corporate governance are discussed below.

2.1.1. Rights and Equitable Treatment of Shareholders

There was a total of 20 questions on various aspects of shareholder rights and their equitable treatment. Questions included, among others, information on the basic shareholder rights (secure method of ownership registration, ease of transferring shares, access to information by shareholders, election of Board members, etc.), the right to participate in fundamental corporate changes, ease of participation in Annual General meetings, equal treatment within the same class of shareholders, disclosure by directors and managers of the relevant information, and efficient and transparent functioning of the market for corporate control. Table 2.6 shows the rankings of different banks according to this aspect. We observe that while 8 banks (57.1 percent) score excellent, 3 banks (21.4 percent) are categorized as good, 2 banks (14.3 percent) rank fair, and only 1 bank (7.1 percent) has poor ranking. It must be noted that rights of shareholders depend, to a large extent, on the company laws under which the banks are incorporated. The relatively better rights of majority of the banks may be a reflection of the law of the country.

Table 2.6. Status of Corporate Governance in Islamic Financial Institutions: Rights and Equitable Treatment of Shareholders

Rankings	Percentage Scores	Number of Banks	Percentage of Total
Excellent	90-100	8	57.1
Good	80-90	3	21.4
Fair	70-80	2	14.3
Poor	Below 70	1	7.1

2.1.2. Other Rights and Equitable Treatment of Stakeholders

Results derived from 10 questions regarding other stakeholders are reported in Table 2.7. Questions in this aspect included the rights and incentives of depositors and employees, the role of the *Sharī'ah* board, and the bank's involvement in social development activities. The results show that only 4 institutions (28.6 percent) score good or

excellent. More than one-third of the Islamic banks (5 or 35 percent) have a rank of fair and the same fraction performs poorly. The results indicate that most banks do not perform well when it comes to rights of other stakeholders.

Table 2.7. Status of Corporate Governance in Islamic Financial Institutions: Other Stakeholders

Rankings	Percentage Scores	Number of Banks	Percentage of Total
Excellent	90-100	2	14.3
Good	80-90	2	14.3
Fair	70-80	5	35.7
Poor	Below 70	5	35.7

Table 2.8. Status of Corporate Governance in Islamic Financial Institutions: Responsibilities of the Board

Rankings	Percentage Scores	Number of Banks	Percentage of Total
Excellent	90-100	7	50.0
Good	80-90	5	35.7
Fair	70-80	1	7.1
Poor	Below 70	1	7.1

2.1.3. Responsibilities of the Board

There were 15 questions related to responsibilities of the board in running the bank. The questions enquired if the board members were qualified, give enough time to their duties, protect the rights of shareholders, depositors, and the institution, and perform key functions (like setting corporate strategy, risk policy, performance plans, monitoring and replacing management, ensuring the integrity of the accounting and financial reporting systems, and compliance with the law and the *Sharī'ah*). The results in Table 2.9 show that half of the banks in the sample (50 percent) rank excellent and around a third (35.7 percent) rank good. One bank is ranked fair and another one poor. The results are similar to those of the rights of shareholders and may be a reflection

of the company laws that define to a large extent the responsibilities of the Board.

2.1.4 Disclosure and Transparency

Disclosure and transparency category had 10 questions on issues like disclosure on material information of the financial and operating results, objectives, major share ownership and voting rights, risks, governance structure policies. Questions on preparation of audit and disclosures according to high standards of accounting and timely dissemination of information were also asked. The summary of results in this category is reported in Table 2.9. The results show that 6 banks (42.9 percent) have excellent disclosure and transparency systems, 5 (35.7 percent) are ranked good, 2 (14.3 percent) are ranked fair and 1 is ranked poor. On an average, the disclosure and transparency mechanism appear to be positive. One explanation for this may be the disclosure and transparency requirements imposed by the regulators.

Table 2.9. Status of Corporate Governance in Islamic Financial Institutions: Disclosure and Transparency

Rankings	Percentage Scores	Number of Banks	Percentage of Total
Excellent	90-100	6	42.9
Good	80-90	5	35.7
Fair	70-80	2	14.3
Poor	Below 70	1	7.1

Table 2.10. Status of Corporate Governance in Islamic Financial Institutions: Management of Bank Operations

Rankings	Percentage Scores	Number of Banks	Percentage of Total
Excellent	90-100	3	21.4
Good	80-90	6	42.9
Fair	70-80	2	14.3
Poor	Below 70	3	21.4

2.1.5 Management of Bank Operations

There are 22 questions on the management of bank operations relating to the way the institution is run. Specific questions include, among others, information on the division of authority among the board and the management, guidelines and policies for different departments, risk management system, internal control system, reporting systems, level of technology used, and training of employees. Results for this element of corporate governance are reported in Table 2.10. We observe that only 3 banks (21.4 percent) have excellent performance with regard to management of bank operations, while 6 banks (42.9 percent) are ranked as good, 2 banks have fair performance, and 3 (21.4 percent) have poor management.

2.2. External Factors

External factors determine the environment under which Islamic financial institutions operate. With the exception of a few countries, Islamic financial institutions operate in an environment that has both conventional and Islamic institutions. In these countries, Islamic banks have to adapt and accommodate their operations to the environment designed for their conventional counterparts. We discuss the views of financial institutions regarding the external factors that affect corporate governance.

2.2.1 Regulatory Regime

There were 8 questions related to the regulatory regime under which Islamic financial institutions operate. These questions enquire about the status and independence of the regulator, the attitude of the regulatory regime towards Islamic banks, the investigative authority and ability of the regulator, and regulatory requirements regarding auditing and disclosure. Results in Table 2.11 show that 4 banks (28.6 percent) rank the regulatory regime as excellent. The same number of banks rank the regime as good and fair. Only 2 banks (14.3 percent) think that the regulatory regime under which they operate is poor.

Table 2.11. Status of Corporate Governance in Islamic Financial Institutions: Regulatory Regime

Rankings	Percentage Scores	Number of Banks	Percentage of Total
Excellent	90-100	4	28.6
Good	80-90	4	28.6

Fair	70-80	4	28.6
Poor	Below 70	2	14.3

Table 2.12. Status of Corporate Governance in Islamic Financial Institutions: Legal Procedures

Rankings	Percentage Scores	Number of Banks	Percentage of Total
Excellent	90-100	4	28.6
Good	80-90	1	7.1
Fair	70-80	6	42.9
Poor	Below 70	3	21.4

2.2.2 Legal Procedures

There were 7 questions that determine the legal procedures related to Islamic financial institutions. The issues enquired were the speed and costs of access to legal process, tradition of commercial arbitration, independence of court decisions, and the enforcement of legal decisions. The results reported in Table 2.12 indicate that only 5 banks (35.7 percent) show the legal procedures to be good or excellent. A large number of financial institutions (42.9 percent) reveal that the legal procedures are fair, and 2 banks (14.3 percent) find them to be poor.

2.2.3. Ethical Overlay

Ethical overlay questions try to identify if corrupt practices influence business transactions, if criminal groups have a role in the economy, and if the law enforcing bodies can effectively combat criminal activities. The results summarized from 6 questions are reported in Table 2.13. We notice that the views on ethical overlay are divided. While 50 percent (7 banks) indicate the ethical overlay to be excellent, almost a third (35.7 percent) indicate it to be poor. One bank's answers indicate the ethical environment to be fair. Note that one bank did not respond to questions of this section.

Table 2.13. Status of Corporate Governance in Islamic Financial Institutions: Ethical Overlay

Rankings	Percentage Scores	Number of Banks	Percentage of Total
Excellent	90-100	7	50.0
Good	80-90	0	0
Fair	70-80	1	7.1
Poor	Below 70	5	35.7

Note: The total does not add up to 100 because one bank did not respond to the questions.

2.3. Overall Evaluation of the Status of Corporate Governance

In this section, we report the results on the overall corporate governance status in Islamic financial institutions. We do this in two ways. First, we find the average percentage scores and rankings across all the aspects of corporate governance (internal and external) mentioned above for each bank. Second, we summarize the results across financial institutions and find the percentage scores for each of the aspects or elements of corporate governance. The overall averages are discussed below.

2.3.1 Summary of Internal Factors of Corporate Governance

The results reported in Table 2.14 summarize the percentage scores for the five elements discussed under internal factors above in Section 2.1 (rights and equitable treatment of shareholders and other stakeholders, responsibilities of the board, disclosure and transparency, and management of the bank's operations). Only 4 financial institutions (28.6 percent) indicated excellent corporate governance status with respect to the internal factors, followed by 5 banks (35.7 percent) that rank it as good. Four banks (28.6 percent) in the sample have fair internal corporate governance status, while one bank's performance is poor.

Table 2.14. Status of Corporate Governance in Islamic Financial Institutions: Internal Factors

Rankings	Percentage Scores	Number of Banks	Percentage of Total
Excellent	90-100	4	28.6
Good	80-90	5	35.7
Fair	70-80	4	28.6
Poor	Below 70	1	7.1

Table 2.15. Overall Status of Corporate Governance in Islamic Financial Institutions

Rankings	Percentage Scores	Number of Banks	Percentage of Total
Excellent	90-100	2	14.3
Good	80-90	8	57.1
Fair	70-80	3	21.4
Poor	Below 70	1	7.1

2.3.2 Overall Status of Corporate Governance

Table 2.15 summarizes the results for the internal and external factors of corporate governance indicated above in Sections 2.1 and 2.2. We notice that 2 banks (14.3 percent) perform excellent and 8 banks (57.1 percent) perform good when we consider all aspects of corporate governance. The corresponding numbers are 3 (21.4 percent) and 1 (7.1 percent) for those performing fair and poor respectively.

2.3.3 Aspects of Corporate Governance: Summary of Results Across Banks

To get an indication of the status of different aspects of corporate governance, we average the results for each aspect across financial institutions. The results are reported in Table 2.16. As for internal factors, 'Rights and Equitable Treatment of Shareholders' appear to be good with an average score of 87.7 percent. The 'Rights of Other Stakeholders', however, is only 72.4 percent indicating 'fair' rank. Note that this figure (72.4 percent) is towards the lower limit of the ranking range for 'good' (i.e., 70-80 percent). The results show that the status of 'Responsibilities of Board' and 'Transparency and Disclosure' is good with an average score of 87.9 percent. Management of the bank's

operations, however, indicates 'fair' performance with an average score of 76.2 percent. The overall performance of the internal factors of corporate governance has an average percentage score of 82 percent and ranks as 'good'.

Table 2.16. Corporate Governance in Islamic Financial Institutions: Summary of Results Across Financial Institutions

	Average Percentage Score	Rankings
Rights and Equitable Treatment of Shareholders	87.7	Good
Rights of Other Stakeholders	72.4	Fair
Responsibilities of the Board	87.9	Good
Disclosure and Transparency	87.9	Good
Management of Bank Operations	76.2	Fair
Internal Factors Average	***82.0***	***Good***
Regulatory Regime	81.3	Good
Legal Procedures	76.9	Fair
Ethical Overlay	82.5	Good
External Factors Average	***78.5***	***Fair***

The results from external factors show that while the 'Regulatory Regime' and 'Ethical Overlay' can be categorized as 'good', their average percentage scores (of 81.3 percent and 82.5 percent respectively) are, however, closer to the lower limit of the ranking range (of 80-90 percent). The 'legal procedures' aspect ranks 'fair' with an average percentage score of 76.9 percent. An average percentage score of 78.5 percent ranking of the external factors as a whole indicates that the status of corporate governance is 'fair' for the same.

3. Depositors

Field level interviews were conducted with the depositors of Islamic banks in Bahrain, Bangladesh, and Sudan. The field surveyors visited different branches of banks and picked depositors randomly for interviewing. In Bahrain, 153 depositors from 3 banks were interviewed. A total of 165 depositors were interviewed in Bangladesh from 4 banks and 150 depositors from 7 banks in Sudan. A list of banks along with the number of depositors interviewed in three countries is given in Table 3.1. Note that some of the depositors did not respond to certain questions.

The results reported here indicate the number of total responses received for each question and uses this number to arrive at percentages.

Depositors are an important stakeholder and have a crucial role to play in the governance of banks. This is true more so in the case of Islamic banks as investment depositors are essentially partners with the bank and rewarded on a profit-loss sharing basis. In this section, we discuss different issues related to depositors in the light of their role in corporate governance. One important issue that concerns depositors as 'principals' is how well the banks perform their fiduciary duties of an 'agent' in terms of conducting business efficiently and according to the principles of the *Sharī'ah*. The depositors can use market discipline to improve governance in banks by withdrawing funds from poor performing institutions. To do this, however, the depositors have to understand the nature of Islamic banking and be well informed about the management and performance of the bank. Other than reporting some basic characteristics and preferences of depositors, the questions inquire about their role as a stakeholder, their views on how informed they are, their reactions in case the bank does not perform well, and their opinions on their role in the management of banks.

Table 3.2 reports data on age and education of depositors in our sample. The average age of depositors is 34.5 years in Bahrain, 36.5 in Bangladesh, and 39.7 in Sudan. The maximum age reported in all three countries is above 70 years and the minimum below 20 years. The dispersion of age within the sample is highest in the case of Bangladesh (standard deviation of 13.2) and almost the same for Bahrain and Sudan (standard deviations of 10.5 and 11 respectively). The average years of education for the three countries appear similar. While the average years of education is 14.2 years in Bangladesh, it is 13.7 years in Bahrain and 13.1 in Sudan. Bahrain has both the highest and the lowest cases of education (at 20 years and 2 years respectively). The relatively low standard deviations for all three countries indicate that most of the depositors have education that is close to the mean. The depositors of Islamic banks appear to be relatively well educated as they have one to two years of education beyond high school on the average.

Table 3.1. List of Banks from which Depositors were Interviewed

	No. of Observations
Bahrain	
Shamil Bank	106
Bahrain Islamic Bank	46
Al-Rajhi Bank	1
Total	***153***
Bangladesh	
Islami Bank Bangladesh Ltd.	93
Al Arafah Bank	52
Social Investment Bank Ltd.	18
Al Baraka Bank	2
Total	***165***
Sudan	
Tadamon Islamic Bank	35
Bank of Khartoum	22
Omdurman National Bank	20
Al Gharb Bank	25
Farmer's Commercial Bank	11
Sudanese Islamic Bank	12
Faisal Islamic Bank	16
Others	9
Total	***150***

Table 3.2. Age/Education Characteristics of Depositors

	Bahrain	Bangladesh	Sudan
Age			
Number of Respondents	152	164	147
Average	34.5	36.5	39.7
Maximum	71	76	72
Minimum	18	17	19
Standard Deviation	10.5	13.2	11
Education			
Number of Respondents	150	158	146
Average	13.7	14.2	13.1
Maximum	20	19	18
Minimum	2	5	6
Standard Deviation	2.8	2.7	2.5

Occupations of the depositors in the sample of 3 countries are reported in Table 3.3. We notice that while the largest percentage of depositors of Islamic banks in Bahrain are government employees (50 percent), for Bangladesh and Sudan it is businessmen (with 40.5 percent and 34 percent respectively). Other major occupation for the depositors of Islamic banks is private sector employment. In Bahrain 43 depositors (29.1 percent) report that they are employed in the private sector. The corresponding numbers for Bangladesh and Sudan are 51 and 30 (31.3 percent and 20 percent respectively). Ten respondents (around 6 percent) in Bahrain and Bangladesh and 1 depositor in Sudan (0.7 percent) report to be unemployed. The occupation in the 'other' category is small for Bahrain and Bangladesh (2 percent and 2.5 percent respectively), but high for Sudan (at 20.7 percent). Most of the depositors in this category in the former two countries are retired, while in later it includes farmers. Note that in case of Bahrain and Bangladesh, the percentages add up to more than 100 percent as some depositors have multiple occupations (like combination of private sector employment and business).

Table 3.3. Occupation Status of Depositors*

	Bahrain	**Bangladesh**	**Sudan**
Number of Respondents	148	163	150
Government Employment	74 (50)	14 (8.6)	21 (14)
Private Sector Employment	43 (29.1)	51 (31.3)	30 (20)
Business	25 (16.9)	66 (40.5)	51 (34)
Student	6 (4.1)	25 (15.3)	16 (10.7)
Unemployed	10 (6.8)	10 (6.1)	1 (0.7)
Others	3 (2)	4 (2.5)	31 (20.7)

NOTE: The numbers in parentheses are percentages of the total respondents.
* The percentages can add up to more than 100 percent as some respondents have multiple occupation.

Depositors' dealings with other banks are reported in Table 3.4. While 37 depositors (24.2 percent) in Bahrain indicate that they do not have accounts in other banks (other than the one they were interviewed

at), the corresponding numbers for Bangladesh and Sudan are relatively high at 74 and 73 respectively (with corresponding percentages of 44.8 and 48.7 respectively). The number of depositors who have accounts in other banks in Bahrain is relatively high. About 42 percent of the depositors have accounts is other Islamic banks and 43 percent of them also use conventional banks. In Bangladesh, 84 depositors (50.9 percent) indicate that they have accounts in conventional banks and 18 (10.9 percent) have dealings with other Islamic banks. As there are no conventional banks in Sudan, more than half of the depositors (51.3 percent) have accounts in other Islamic banks. Again the percentages add up to more than 100 percent for Bahrain and Bangladesh as depositors have multiple accounts.

Table 3.4. Accounts in Other Banks*

	Bahrain	Bangladesh	Sudan
Number of Respondents	153	165	150
No other accounts	37 (24.2)	74 (44.8)	73 (48.7)
Account in another Islamic bank	64 (41.8)	18 (10.9)	77 (51.3)
Account in conventional bank	66 (43.1)	84 (50.9)	-

NOTE: The numbers in parentheses are percentages of the total respondents.
* The percentages can add up to more than 100 percent as some respondents have accounts in multiple banks.

Table 3.5. Type of Accounts*

	Bahrain	Bangladesh	Sudan
Number of Respondents	151	164	149
Current Account	63 (41.7)	60 (36.6)	99 (66.4)
Saving Account	111 (73.5)	91 (55.5)	33 (22.2)
Investment Account	22 (14.6)	31 (18.9)	42 (28.2)

NOTE: The numbers in parentheses are percentages of the total respondents.
* The percentages can add up to more than 100 percent as some respondents have multiple accounts.

Table 3.5 reports the types of accounts that depositors have in the Islamic banks where they were interviewed. In Bahrain 63 depositors (41.7 percent) have current accounts, 111 of them (73.5 percent) have saving accounts, and only 22 (14.6 percent) have investment accounts. Similar trend is observed in Bangladesh where 60 respondents (36.6 percent) have current accounts, 91 (55.5 percent) have saving account, and 31 (18.9 percent) have investment accounts. While in Bahrain and Bangladesh the majority of the depositors have saving accounts, in Sudan, most of them have current accounts. There are 99 current account holders (66.4 percent), 33 with saving accounts (22.2 percent), and 42 depositors (28.2 percent) have investment accounts in Sudan

Table 3.6. Reasons for Using Islamic Banks*

	Bahrain	Bangladesh	Sudan
Number of Respondents	149	164	-
Not to deal with *Ribā*	134 (89.9)	82 (50.0)	-
Better Services	23 (15.4)	84 (51.2)	-
Others	4 (2.7)	38 (23.2)	-

NOTE: The numbers in parentheses are percentages of the total respondents.
* The percentages add up to more than 100 percent as some respondents have multiple responses.

Table 3.7. Services of Islamic Banks Compared to Other Banks[a]

	Bahrain	Bangladesh	Sudan
Number of Respondents	152	163	115
Better	69 (45.4)	111 (68.1)	50 (43.5)
Same	52 (34.2)	44 (27.0)	64 (55.7)
Worse	31 (20.4)	8 (4.9)	1 (0.87)

NOTE: The numbers in parentheses are percentages of the total respondents.
a - All banks in Sudan are Islamic.

The depositors were asked why they use Islamic banks only in Bahrain and Bangladesh as this question is not relevant for Sudan where all banks are Islamic. Table 3.6 shows that an overwhelming number of respondents in Bahrain (89.9 percent) choose Islamic banks because they want to avoid *ribā*. The corresponding number in Bangladesh is 82 respondents (50 percent). In Bangladesh, a large number of depositors (51.2 percent) use Islamic banks because they get better service. The corresponding number is only 23 depositors (15.4 percent) in Bahrain. While only 4 respondents (2.7 percent) pointed out other reasons for their dealings with Islamic banks in Bahrain, this number is 38 (23.2 percent) for Bangladesh. The reasons given for this answer include, among others, proximity to residence/office, requirement by the employer, and because parents/relatives/friends have accounts in the banks.

Table 3.7 shows how the depositors in the sample rank the services of Islamic banks if they deal with other banks. Note that other than Sudan, 'other banks' in this question implies conventional banks. In Bahrain 69 respondents (45.4 percent) rank the services of Islamic banks better than other banks, 52 of them (34.2 percent) think the services to be the same, and 31 (20.4 percent) rank services of Islamic banks poorer than other banks. In the case of Bangladesh, 111 respondents (68.1 percent) indicate the services of Islamic banks to be better, 44 of them (27 percent) rank the services at equal par with other banks, and only 8 (4.9 percent) think the services to be inferior to those in other banks. In Sudan, the majority of depositors (55.7 percent) are of the opinion that the services at Islamic banks are similar to those of other banks, 50 respondents (43.5 percent) think that the services provided by their bank are better than those of other Islamic banks, and one depositor ranks the services to be poorer.

Table 3.8. Depositors' Knowledge about the Bank Management and their Accounts

	Bahrain			Bangladesh			Sudan		
	No. of Res.	Affirmative Responses	% of Total	No. of Res.	Affirmative Responses	% of Total	No. of Res.	Affirmative Responses	Percent of Total
Looks at Annual Report	152	25	16.4	165	56	33.9	148	50	33.8
Knows the Name of CEO/GM	153	20	13.1	164	14	8.5	150	97	67.7
Provided with Regular Income Statements	150	108	72	165	114	69.1	96	42	43.8
Can Get Info. On Rate of Return at any time	143	107	74.8	164	155	94.5	96	52	54.2
Knows that the Bank has a *Sharī'ah* Board	153	97	63.4	164	133	81.1	150	136	90.7
Transfer Funds to Mutual Funds, if available	137	88	64.2	153	68	44.4	97	63	64.9

As mentioned above, depositors can play an important role in disciplining banks by withdrawing funds from banks when they do not discharge well their fiduciary duties as agents and when they do not perform well. But to play this role, they have to be well informed about the operations and management of banks. Table 3.8 reports responses from depositors on some of these issues. When asked if the depositors look at the annual reports of the banks to ascertain their performance, 25 respondents (16.4 percent) in Bahrain, 56 (33.9 percent) in Bangladesh, and 50 (33.8 percent) in Sudan answered in the affirmative. A caveat explains the relatively high numbers for Bangladesh and Sudan. Some of the respondents in these countries have indicated that they do not examine the annual reports of the banks, but get information about their performance from the summary of annual accounts reported in the newspapers.

A key position that determines the overall governance of banks is the chief executive. Upon inquiry if the depositors know the name of the CEO/General Manager of the banks, 20 of them (13.1 percent) in Bahrain, 14 (8.5 percent) in Bangladesh, and 97 (67.7 percent) in Sudan answered in the affirmative (see Table 3.8). One important aspect of the disclosure of information of the accounts of depositors is to issue regular income statements. In Bahrain, 108 respondents (72 percent) indicate they receive regular income statements. The corresponding numbers for Bangladesh and Sudan are 114 and 42 respectively (or 69.1 percent and 43.8 percent respectively). Similarly, when asked if they can get information on the rate of return on their deposits at any time they wanted, 107 respondents (74.8 percent) in Bahrain, 155 (94.5 percent) in Bangladesh, and 52 depositors (54.2 percent) in Sudan answered in the affirmative.

As Islamic banks operate according to the principles of the *Sharī'ah*, a board or council exists in most of these institutions to advise and approve their activities. In Bahrain, 97 depositors (63.4 percent) know that there is a *Sharī'ah* board in the Islamic banks they deal with. The corresponding number for Bangladesh is 133 (81.1 percent) and for Sudan is 136 (90.7 percent). When asked if the depositors would transfer their funds from their accounts in Islamic banks to mutual funds that offered similar risk/return features, 88 respondents (64.2 percent) in Bahrain, 68 (44.4 percent) in Bangladesh, and 63 depositors (64.9 percent) in Sudan indicated that they would.

We now report results of some hypothetical questions that have important implications for corporate governance of banks. These results

reveal the role of depositors in improving governance of banks through market discipline. If the banks fail to perform well and do not perform their fiduciary duties, the depositors will respond by withdrawing funds. This is seen in the results reported in Table 3.9. When asked if the depositors would move their funds to other banks if their bank gave a lower rate of return than other banks, 18 respondents (11.8 percent) in Bahrain, 67 (41.3 percent) in Bangladesh, and 56 (37.6 percent) in Sudan indicated that they will. Note that 1 respondent (0.7 percent) in Bahrain and 30 depositors (18.5 percent) in Bangladesh would move funds to a conventional bank. If an Islamic bank gives a rate of return that is lower than that of other banks for several years, the number of depositors who would move funds to other banks increases significantly. In Bahrain, the number of depositors who will shift funds now increases to 63 (41.2 percent). The corresponding numbers for Bangladesh and Sudan are 109 and 116 respectively (67.3 percent and 77.9 percent respectively). Table 3.9 also shows that the depositors will punish the bank by withdrawing funds if there are rumors about the poor performance of banks. If such rumors arise, 45 depositors (30 percent) in Bahrain, 74 (45.2 percent) in Bangladesh, and 129 (86.6 percent) in Sudan will move to other banks. These results indicate that if Islamic banks do not perform well and do not provide the market comparable rates of return, there is a risk of losing depositors.

Table 3.9. Feedback of Depositors on Corporate Governance Issues

	Bahrain			Bangladesh			Sudan[a]		
	Keep with Bank	Move to Islamic Bank	Move to any Bank	Keep with Bank	Move to Islamic Bank	Move to any Bank	Keep with Bank	Move to Islamic Bank	Move to any Bank
If Bank's Rate of Return is lower than others for one year	135 (88.2)	17 (11.1)	1 (0.7)	95 (58.6)	37 (22.8)	30 (18.5)	93 (62.4)	56 (37.6)	-
If Bank's Rate of Return is lower than others for several years	90 (58.8)	58 (37.9)	5 (3.3)	53 (32.7)	69 (42.6)	40 (24.7)	33 (22.1)	116 (77.9)	-
If there are rumors about poor management of the bank	104 (69.3)	43 (28.7)	2 (1.3)	90 (54.9)	48 (29.3)	26 (15.9)	20 (13.4)	129 (86.6)	-
If the Bank is not doing business according to *Sharī'ah*	21 (13.7)	125 (81.7)	6 (3.9)	54 (33.1)	76 (46.6)	33 (20.2)	8 (5.4)	141 (94.6)	-
If a part of the income of the bank is from interest	30 (19.9)	116 (76.8)	3 (2.0)	61 (37.0)	72 (44.2)	32 (19.6)	49 (32.9)	100 (67.1)	-

NOTE: The numbers in parentheses are percentages of the total respondents.
a – All banks in Sudan are Islamic.

Table 3.9 also reports the possible reactions of depositors if the banks fail to perform their other fiduciary duties related to doing business according to *Sharī'ah.* If the depositors come to know that the bank is not doing its business according to the principles of the *Sharī'ah*, then a large percentage of them (85.6 percentage) will move their funds to other banks in Bahrain. The number of depositors who will move their funds from the bank due to non-abidance of *Sharī'ah* is 109 (66.8 percent) in Bangladesh and 141 (94.6 percent) in Sudan. Note that in Bahrain and Bangladesh, not all depositors indicate that they will transfer funds to another Islamic bank. Similar results appear in the responses of depositors when asked about their reaction if they come to know that a part of the income of the banks is from interest. If such case arises, then 119 depositors (78.8 percent) in Bahrain, 104 (63.8 percent) in Bangladesh, and 100 respondents (67.1 percent) in Sudan will shift their funds to another bank.

Table 3.10. Depositors Role in Management

	Bahrain	Bangladesh	Sudan
Number of Respondents	132	165	98
Should have a Role	72 (54.5)	91 (55.2)	71 (72.4)
Representation in the Board	39 (54.2)[a]	31 (34.1)[a]	9 (12.7)[a]
Representation in AGM	33 (45.8)[a]	57 (62.6)[a]	60 (80.5)[a]

NOTE: The numbers in parentheses are percentages of the total respondents.
a - The percentages represent those that had affirmative answers (72 respondents for Bahrain, 91 for Bangladesh, and 71 for Sudan).

Finally, Table 3.10 shows the opinions of depositors regarding the role they should play in the management of the banks. In Bahrain, 72 depositors (54.5 percent) indicate that depositors should have a say in the management of the bank. Of these 39 respondents (54.2 percent of 72) think that the depositors should be represented in the board and 33 of them say they should be able to attend the annual general meeting (AGM). In Bangladesh 91 depositors (55.2 percent) are of the view that they should have a say in running the bank, 31 of these prefer representation in the board and 57 respondents would like to participate in the AGM. Similarly, in Sudan 71 respondents (72.4 percent) think that depositors should have a role in management of the bank. While most of these respondents (60 depositors or 80.5 percent) would prefer to attend

the AGM, only 9 of them think representation in the board would be appropriate.

4. Summary of the Results and Assessment

The Survey of the regulators, Islamic financial institutions, and depositors shows that there is variation of corporate governance environment and status in different countries. Summary of the results found at three levels of the Survey along with their assessment are given below.

4.1 Regulators

Results from the Survey show that, while the overall regulatory environment in the countries included in the study is relatively good (with an average of 73.6 percent in Table 1.2), the regulatory environment for Islamic banks calls for improvement (with an average of 46.4 percent in Table 1.4). The results also indicate that there is relatively less variation in the overall regulatory regimes in the countries in the sample (with a standard deviation of 0.93 in Table 1.3). The variation in Islamic regulatory regimes, however, is relatively more (with a standard deviation of 3.15 in Table 1.5). When it comes to the perceptions of the regulators with respect to risks involved in Islamic banks compared to conventional banks, the results show that the dominant view (56.4 percent in Table 1.6) is that there is no difference between the two. This perception may explain the relative weakness of the regulatory regime for Islamic banks. If the regulators think there is little difference between Islamic banks and conventional banks, there is no justification to establish separate supporting institutions for Islamic banks.

4.2. Islamic Financial Institutions

We have discussed the status of corporate governance in Islamic financial institutions by looking at different aspects that can be broadly categorized as internal and external factors. It should be noted that the results show a lot of variation in the status of corporate governance structures in different Islamic financial institutions. We, however, can deduce certain general conclusions of corporate governance from the average results found in the Survey. These are discussed below.

While the overall environment under which the financial institutions operate is reflected in the results of the external factors (i.e., the regulatory regime, the legal procedures, and the ethical overlay), the laws and regulations of a country are also reflected in the internal factors

of governance. Among the factors that may be affected by laws are issues like shareholder rights and responsibilities of the board. Similarly, regulators can set the basic disclosure and transparency principles and requirements that financial institutions must follow. Our results indicate that these aspects (rights of shareholders, responsibilities of the board, and disclosure and transparency) score relatively better among the internal factors of corporate governance as they have a ranking of 'good' on the average. Rights of other stakeholders and the management of the bank, however, do not perform well. These aspects of corporate governance score 'fair'. The results also indicate that among the external factors the 'regulatory regime' and 'ethical overlay' on the average have 'good' ranking, but the 'legal procedures' performance is 'fair'.

When we compare the internal and external factors of corporate governance, we observe that the former factors on the average perform better than the latter. The implication of these results is that Islamic financial institutions operate in an environment that is not friendly. This can be seen in the averages of the internal and external factors in Table 2.16 (with a ranking of 'good' for the former and 'fair' for the latter). This pattern is also reflected in Tables 2.14 and 2.15. We notice that when we compare the average scores of the internal factors (in Table 2.14) with that of the overall case that includes internal and external factors (Table 2.15), we notice that number of banks in the 'excellent' ranking falls from 4 to 2 in the latter. While there is one bank, which moves up to 'good' ranking from 'fair', the implication of the results presented above is that the external environment is not playing a facilitating role in improving the overall status of corporate governance in Islamic financial institutions.

The results indicate that the performance of Islamic financial institutions is moderately good. There is, however, room for improvement. While a few Islamic banks have scored excellent in certain aspects of corporate governance, we notice in many cases they are in the fair and poor categories. Moreover, none of the averages score 'excellent' rank. Improvement in corporate governance in Islamic financial institutions needs progress in both the internal and external factors identified above. The government and regulators are responsible for improvement of the external governance environment. While Islamic banks cannot control the external factors, they can influence the internal aspects of corporate governance. In particular, the results show that there is a need to improve the rights of stakeholders and the management of banks.

4.3. Depositors

While there are similarities in the age and education profiles of depositors in different countries, we observe that there are differences in their attitudes towards their dealings with Islamic banking. Most of the depositors of Islamic banks appear to be relatively highly educated. Most of the depositors are employed by the government (50 percent) in Bahrain and the main occupation of respondents in Bangladesh and Sudan is business (40.5 percent and 34 percent respectively). In case of Bahrain and Bangladesh a large number of depositors indicate that they also have accounts in conventional banks (43.1 percent and 50.9 percent respectively).

Most of the depositors in Sudan have current accounts in Islamic banks (66.4 percent), but the majority of the respondents have saving accounts in Bahrain and Bangladesh (73.5 percent and 55.5 percent respectively). While an overwhelming majority of depositors (89.9 percent) in Bahrain indicate that they Islamic banks to avoid *ribā*, the opinion is divided in Bangladesh. Almost half of the depositors (51.2 percent) there use Islamic banks as they provide better services. In Bahrain and Bangladesh, the depositors rank the services provided by Islamic banks better than others, while in Sudan the majority thinks it to be the same as others.

The Survey reveals that a majority of the depositors interviewed in three countries are of the opinion that they should have a role in the management of the bank. While most of the depositors in Bahrain think this role should be representation in the board, the majority of the respondents in Bangladesh and Sudan prefer attendance in AGMs. The results from the Survey also discover important feedbacks from depositors that have implications for market disciplining aspects of corporate governance. The results from all three countries show that depositors will punish the banks if they are not rewarded with rates of return comparable to those of the market and if they do not do their transactions according to *Sharī'ah*. Furthermore, rumors regarding the poor performance of the bank may also lead to withdrawals. All these results indicate that depositors can impose good corporate governance on banks through market discipline mechanisms. To retain depositors banks have to perform well (give good rates of return and avoid actions that can lead to rumors) and abide by the *Sharī'ah* rules.

APPENDIX 1

Part 2: Questionnaires Used in the Survey

ISLAMIC DEVELOPMENT BANK
ISLAMIC RESEARCH & TRAINING INSTITUTE

PROJECT ON
"CORPORATE GOVERNANCE IN ISLAMIC FINANCIAL INSTITUTIONS"

Questionnaire for Regulators/Supervisors

GENERAL

1. Name of the institution and address ____ ______ ____

2. Respondent's Name:_____________________________________ ___
   Position: ____

I. Rules and Regulations: General
Please mark the appropriate boxes with ✕.

	YES	NO
1. Are Basel Committee Core Principles recommendations adopted as the guidelines for rules and regulations in the country?		
2. Does the regulatory organ require financial institutions to get ratings from international rating agencies?		
Is there any institutional setup for deposit protection or insurance?		
4. Can financial institutions engage in multiple activities (banking, trading, insurance, etc.)?		
5. Does the central bank or any other agency in the country develop standards and risk management procedures for banks and financial institutions?		
6. Does the regulatory agency require risk-based capital requirements for banks and financial institutions?		
7. Are international standards of accounting and auditing adhered to in financial institutions as a matter of		

routine?		
8. Are there any standards for corporate governance set for financial institutions?		
9. Are financial institutions required to provide any guidelines of their corporate governance structures and practices?		
10. Are the financial institutions required to submit standardized reports to the regulators regularly?		

II. Regulatory Regime for Islamic banks
Please mark the appropriate boxes with ✕.

	YES	NO
1. Does any existing law have any provision for Islamic banking and financial institutions?		
Are there separate set of rules and regulations governing Islamic financial institutions?		
3. Is there a separate department/office in the central bank that deals with Islamic banks?		
4. Does the central bank or any other agency in the country develop standards and risk management procedures particular for Islamic financial institutions?		
5. Does the central bank have special discount windows facilities for Islamic financial institutions?		
6. Are Islamic financial institutions required to adhere to AAOIFI[a] standards of accounting and auditing?		
7. Is there access to redress legal matters for settling disputes relating to Islamic banks?		
8. Do you think there is a general awareness of the risks faced by Islamic banks?		
9. Is there any *Shari'ah* Supervisory Committee/Board at the regulatory level?		
10. Are Islamic financial products/instruments standardized in your jurisdiction?		

a-Accounting and Auditing Organization for Islamic Financial Institutions, Bahrain

III. Islamic Vs Conventional Banks

Please mark the appropriate boxes with ✕.

	More	**Same**	**Less**
1. Compared to Conventional banks, are Islamic banks more/less prone to systemic risk?			
2. Compared to conventional banks, are depositors of Islamic banks more/less protected?			
Compared to conventional banks, do you think Islamic banks should have more/less capital requirements?			
4. Compared to conventional banks, do you think Islamic banks are more/less prone to fraud?			
5. In contracting, does an Islamic financial contract have the same set of rights which one expects to be conferred if the transaction took place in the conventional contract.			
6. Compared to conventional banks, do you think that the accounting and auditing standards of Islamic financial institutions are more/less difficult?			
Compared to conventional banks, the risks of withdrawal faced by Islamic banks on their investment (*muḍārabah*) accounts are more/less?			
8. Compared to Conventional banks, do you think that the Islamic banks create more/less market discipline?			
9. Should the loan loss reserves required by Islamic Banks be			

more/less than conventional banks?			

ISLAMIC DEVELOPMENT BANK
ISLAMIC RESEARCH & TRAINING INSTITUTE

"CORPORATE GOVERNANCE IN ISLAMIC FINANCIAL INSTITUTIONS"

Questionnaire for Management of Islamic Banks and Financial Institutions

1. GENERAL

I. Basic Information

1. Name and location of the Bank: ____________________________
2. Year of Establishment: ___________________________________
3. Respondent's Name: ___________________________________
4. Position: ___________________________________
5. Number of Branches: ___________
6. Number of Employees:__________
7. Nature of Activities: (Please mark the appropriate boxes with ✕)

i. Commercial Banking ☐ v. Investment Banking ☐

ii. Offshore Banking ☐ vi. Foreign Exchange dealers ☐

iii. Investment (including funds)☐ vii. Stock Brokers ☐

iv. Insurance ☐ viii. Others (please specify) ☐

8 Does the institution have a *Sharī'ah* Board? Yes ☐ No ☐

If YES, how many members are there in the *Sharī'ah* Board?_________

9. Rating of the institution by International /National Agencies

Name of the Rating Agency	Rating
(i) ______________________	_____
(ii) ______________________	_____

10. Is your institution member if any Banking Associations? Yes ☐ No ☐
If YES: a). Are these associations for:

1. All banks ☐
2. Islamic banks only ☐

b). Do these Banking associations provide, among others, principles and sound practice standards on management and governance related issues? Yes ☐ No ☐

II. *Ownership and Governance Structures of the Bank/Financial Institution*

1. Legal Status of the Bank:
   Public limited Company ☐ Private limited company ☐

   Partnership ☐ Other ☐
   (please specify)________________

2. Total Capital (Local Currency/US$)______________/US$ ________________

3. Total number of outstanding shares _____________

4. Are there different classes of shares? Yes ☐ No ☐

   If YES, please specify
____

5. a. What is the percentage share of largest single shareholder?___________

   b. What is the percentage share of largest five shareholders?____________

   c. What is the percentage share of largest ten shareholders? __________

6. What is the percentage of shares held by the board of directors? __________

   7. Do the top management officials hold shares of the institution?
   Yes ☐ No ☐

8. Is the CEO of the bank and the Chairman of the Board same person?
   Yes ☐ No ☐

9. Does your institution have any subsidiaries? Yes ☐
   No ☐
   If YES:
   i) Do these subsidiaries have their independent boards? Yes ☐
   No ☐

ii) Do these subsidiaries have their own capital? Yes ☐
No ☐

9. Composition of the Board Members

	Number
Total Number of Directors in the Board	
Executive Board members	
Non-executive board members	
Members from the *Sharī'ah* Board	
Others, please specify	

10. Does the Institution have any of the following bodies

	Yes	**No**	**If YES, No. of Members**
Executive Committee			
Risk Management Committee			
Audit Committee			
Compensation/Remuneration Committee			
Nomination (of Board) Committee			
Corporate Governance Committee			

III. Financial Information

1. Most Recent Basic Balance Sheet Figures: (Year _______________)

	Local Currency	**US$**
Total Assets		
Total Liabilities		
Equity (Capital)		

2. Comparative Rates of Return (in percentage) for Depositors and Equity Holders and Default Rates (US$)

Rate of Return on:	1999	2000	2001
Your Bank's Equity Holders (dividend share %)			
Investment Deposits of your bank (average)			
Investment Deposits of competing Islamic Banks (average)			
Investment Dep. of Competing Commercial Banks (average)			
Non-Performing Loans and Default Rates			
Non-performing loans for 6-9 months			

(amount in mil.)			
Non-performing loans for 9-12 months (amount in mil.)			
Non-performing loans for more than a year (amount in mil.)			

II. ISSUES ON CORPORATE GOVERNANCE

Please mark the appropriate boxes with ✕.

I: Equitable Treatment of Shareholders

	FO[a]	LO[a]	MNO[a]	NO[a]
. Equal treatment of shareholders within same class				
Same voting rights for shareholders within each class. Ability to obtain information about voting rights attached to all classes before share acquisition. Changes in voting rights subject to shareholder vote.				
2. AGM processes and procedures allow for equitable treatment. Avoidance of undue difficulties and expenses in relation to voting.				
. Prohibition of insider-trading and self-dealing				
Disclosure by directors and managers of material interests in transactions or matters affecting the company				

NOTE: a-see below for explanations:
FO – Fully (or always) Observed means that all essential criteria are generally met without and significant deficiencies
LO – Largely (or usually) Observed **means that only minor shortcomings are observed, which do not raise any questions about the authorities' ability and intent to achieve full observance within a prescribed period of time.**
MNO – Materially not (or sometimes) observed means that despite progress, the shortcomings are sufficient to raise doubts about the authorities' ability to achieve observance.
NO – Not (or never) observed means that no substantive progress has been achieved
For questions with Yes/No answers, use '**FO'** for 'Yes'**,** and '**NO'** for 'No'.

II. The Rights of Share Holders

	FO[a]	LO[a]	MNO[a]	NO[a]
A. Basic Shareholder Rights:				
1. Secure methods of ownership registration				
2. Ease of transferring				

shares				
3. Access to information by shareholders				
4. Participation and voting at Annual General Meetings				
5. Election of Board				
6. Share in Profit				
B,. ***Right to participate on fundamental corporate changes:***				
1. Amendments to the statutes				
2. Authorization of additional shares				
3. Extraordinary transactions (e.g., sale of the institution)				
C. The right to be adequately informed about, participate and vote in general shareholder meetings (AGM):				
1. Sufficient and timely information about AGM				
2. Opportunity to ask questions and place items on agenda				
3. Vote in person or in absentia				
D. Disclosure of information on capital structure and arrangements enabling control disproportionate to equity ownership				
E. Efficient and transparent functioning of market for corporate control:				
1. Clearly articulated and disclosed rules and procedures, transparent prices and fair conditions				
2. No use of anti-takeover devices to shield management from accountability				
3. Vote by custodians or nominees in agreement with beneficial owner				

NOTE: a-see below for explanations:

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MNO – Materially not (or sometimes) observed (means that despite progress, the shortcomings are sufficient to raise doubts about the authorities' ability to achieve observance.

NO – Not (or never) observed means that no substantive progress has been achieved

For questions with Yes/No answers, use '**FO**' for 'Yes', and '**NO**' for 'No'

III: Other Stakeholders

	FO[a]	LO[a]	MNO[a]	NO[a]

1. Respect of Depositors rights (withdrawal and profit share)				
2. *Means to redress for violation of rights of stakeholders*				
3. *Availability of information on the performance of the bank to the depositors*				
4. *Investment depositors representation in Board meetings or shareholders meetings.*				
5. *Existence of some organ that represents the interests/rights of employees (e.g., trade union)*				
6. *Performance bonuses for employees*				
7. *Interest-free loans for employees*				
8. *A statement of business practices or code of ethics known to all the employees of the institution*				
9. Representative(s) of the *Sharī'ah* Board participates in the board meetings.				
10. *The Sharī'ah Board reviews and approves new products and instruments that are introduced by the institution*				
11. *The Sharī'ah board reviews and supervises the operations of the institution.*				
12. The *Sharī'ah* Board ensures that the operations of the Bank are in harmony with *Sharī'ah*.				
13. Arrangement for collection and distribution of *zakat* of shareholders and depositors				
14. The bank is involved in social development activities				

IV: Disclosure and Transparency

	FO[a]	**LO**[a]	**MNO**[a]	**NO**[a]
Disclosure of material information given on:				
1. Financial and operating results				
2. Company objectives				
3. Major share ownership and voting rights				
4. Board members, key executives, and their remuneration				
5. Material foreseeable risk factors				
6. Material issues regarding employees and other stakeholders				
7. Governance structures and policies				

. Preparation of information, audit, and disclosure in accordance with high standards of accounting, disclosure, and audit				
C. Annual audit by independent auditors				
D. Channels of disseminating information allow for fair, timely, and cost efficient access to information by users.				

NOTE: a-see below for explanations:

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V: Responsibilities of the Board

	FO[a]	LO[a]	MNO[a]	NO[a]
Act on informed basis, in good faith, with due diligence and care, in the best interest of the institution and shareholders				
Protect and oversee the rights of the depositors				
. Fair treatment of each class of shareholders				
D. ***Compliance with law and taking into account stakeholders interests***				
E. ***Key functions:***				
1. Corporate strategy, risk policy, budgets, business plans, performance objectives, implementation and performance surveillance, major capital expenditure, acquisitions, divestures				
2. Selection, monitoring, replacement of key management				
3. Key executive and board remuneration, board nomination				
4. Monitoring of conflict of interest of management, board members, and shareholders, depositors, including misuse of corporate assets and abuse in related party transactions				

Ensuring integrity of accounting and financial reporting systems, including independent audit, systems of control, compliance with law				
Monitoring management practices and making necessary changes				
7. Overseeing disclosure and communication				
8. Fiduciary responsibility that the operations of the institution conforms to *Shari'ah*				
F. *Objective judgment on corporate affairs:*				
1. Assignment of non-executive board members to tasks of potential conflict of interest (e.g., financial reporting, remuneration)				
2. Devote sufficient time to their responsibilities				
G. *Access to accurate, relevant, and timely information*				

VI. Legal Procedures

	FO[a]	**LO[a]**	**MNO[a]**	**NO[a]**
1. Access to redress through legal process reasonably practicable for most Islamic banks				
2. Redress through legal process reasonably speedy				
3. Access to legal redress reasonably cost effective				
4. A strong tradition of effective commercial arbitration				
5. Court decisions largely influenced by commercial, political, or improper considerations				
6. An effective system for ensuring respect and enforcement of legal decisions operate in the country				
7. Difficult to evade the consequences of legal judgments against entities				

NOTE: a-see below for explanations:

FO – Fully (or always) Observed means that all essential criteria are generally met without and significant deficiencies

LO – Largely (or usually) Observed **means that only minor shortcomings are observed, which do not raise any questions about the authorities' ability and intent to achieve full observance within a prescribed period of time.**

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NO – Not (or never) observed means that no substantive progress has been achieved

For questions with Yes/No answers, use '**FO**' for 'Yes', and '**NO**' for 'No'.

VII. Regulatory Regime

	FO[a]	LO[a]	MNO[a]	NO[a]
1. The bank regulators show evidence of consistent and impartial action towards Islamic banks.				
2. The central bank, in its role as a regulator of the banking sector, politically independent of its action.				
There exist effective independent financial watchdogs possessing their own investigative powers and resources.				
4. Regulatory bodies concerned with monitoring operations and improper commercial behavior that possess formidable powers of investigation exist.				
5. The institution's records maintained are thorough, dependable, and up to date, with safeguards against either the submission of inaccurate or untimely information or for tampering with those records.				
6. The disclosure policy includes an assessment of the quality of disclosure of financial and operating results, subsidiaries, shareholders and voting rights, members of the board and their remuneration and issues like contingent liabilities and risks.				
7. The international standards of accounting and auditing adhered to as a matter of routine.				
8. There are more than one institution/organization that supervises/regulates Islamic financial institutions.				

VIII. Ethical Overlay

	FO[a]	LO[a]	MNO[a]	NO[a]
1. Law enforcement and fraud investigative bodies perceived to be ineffective in combating (organized) criminal activity				
2. Evidence of criminal groups playing a significant role in controlling any substantial industry sectors				
3. The country ranked below 30th place within the Transparency International corruption rating system.				
4. The country experience a material level of				

assassinations, kidnappings, or threats to business figures each year				
5. The outcomes of tender processes and other market auctions of commercially valuable rights generally felt to be biased, opaque, and likely to have been influenced improperly				
6. Government officers widely known to expect or require payment for either preferential or basic discharge of their powers				

NOTE: a-see below for explanations:

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LO – Largely (or usually) Observed **means that only minor shortcomings are observed, which do not raise any questions about the authorities' ability and intent to achieve full observance within a prescribed period of time.**

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NO – Not (or never) observed means that no substantive progress has been achieved

For questions with Yes/No answers, use '**FO**' for 'Yes', and '**NO**' for 'No'.

IX. Management of Bank Operations

	FO[a]	LO[a]	MNO[a]	NO[a]
1. The division of authority between shareholders, management, and board members is clearly defined.				
2. A formal system of Risk Management is in place in the organization.				
3. There is section/committee responsible for identifying, monitoring, and controlling various risks.				
4. Te bank has internal guidelines/rules and concrete procedures with respect to the risk management system.				
5. The bank has in place an internal control system capable of swiftly dealing with newly recognized risks arising from changes in environment, etc..				
6. The bank has in place a regular reporting system regarding risk				

management for senior officers and management?				
7. There is an Internal Auditor responsible to review and verify the management systems, guidelines, and risks.				
8. The bank has countermeasures (contingency plans) against disasters and accidents.				
9. The members of the board and management are able to assess the true risks inherent in Islamic banks.				
10. There is a computerized support system for estimating the variability of earnings and risk management.				
11. A clear policy promoting asset quality.				
12. Adopted and utilized guidelines for a loan approval system.				
13. Credit limits for individual counterparty are set and strictly monitored.				
14. Mark-up rates on loans set taking account of the loan grading.				
15. A system for managing problem loans and default.				
16. Bank officials/employees are given regular training.				
17. Separation of duties between those who generate risks and those who manage and control risks.				
18. A reserve that is used to increase the profit share (rate of return) of depositors in low-performing periods.				
19. To keep the rate of return in line with other banks, transferring profit from shareholders to depositors.				
20. Modern technology (ATMs and Internet banking) available to customers.				
21. Different risk reports are prepared for the board.				
22. Restrictions on credit to members of the board and senior management.				

NOTE: a-see below for explanations:
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LO – Largely (or usually) Observed **means that only minor shortcomings are observed, which do not raise any questions about the authorities' ability and intent to achieve full observance within a prescribed period of time.**

MNO – Materially not (or sometimes) observed (means that despite progress, the shortcomings are sufficient to raise doubts about the authorities' ability to achieve observance.
NO – Not (or never) observed means that no substantive progress has been achieved.
For questions with Yes/No answers, use '**FO**' for 'Yes', and '**NO**' for 'No'.

"CORPORATE GOVERNANCE IN ISLAMIC FINANCIAL INSTITUTIONS"

Questionnaire for Depositors

(for Bahrain and Bangladesh)

Name of the bank: ________________ Date: __________________

Respondent's Number:________ Age:______

Education(Years): _________Employment: Government employment

☐ Private sector employment ☐ Business

☐ Student ☐ Unemployed

☐ Others ☐

1. Do you have account in other banks?
   - i. No ☐
   - ii. Islamic bank ☐
   - iii. Conventional bank ☐

2. What kind of Account you have in this bank?
   - i. Current Account ☐
   - ii. Saving Account ☐
   - iii. Investment Account ☐
   - iv. Other ☐

   (Please specify) ____________________________________

3. Why do you use the services of Islamic bank?
   i. Not to deal with *ribā* □
   ii. Good service □
   iii. Other □
   (Please specify)______________________________________

4. How would you rank the services of the bank compared to other banks?
   i. Better □
   ii. Same □
   iii. Worse □

5. Do you look at the Annual Report of the bank to ascertain its performance?
   Yes □ No □

6. Do you think as investment depositors you should have say in the management of the bank?
   Yes □ No □

   If Yes: It should be
   i. Representation in the Board □
   ii. Representation in the Annual General Meetings □

7. Do you know the name of the CEO or President of the bank?
   Yes □ No □

8. If some mutual funds provide similar features of investment account, would you transfer funds from your investment account to mutual funds?
   Yes □ No □

9. Are you provided with regular income statements indicating the rate of return on your deposits?
   Yes □ No □

10. Can you get information on the rate of return on your deposits at any time from the bank if you wanted?
   Yes □ No □

11. Do you know if the bank has a *Sharī'ah* Board?

Yes ☐ No ☐

Please mark the appropriate boxes with ✕.

12. What will you do, if:	**Keep your deposits with the bank**	**Shift deposits to another Islamic bank**	**Shift deposits to any other bank**
a). If the bank's rate of return is lower than other banks in **one year**			
b). If the bank's rate of return is lower than other banks for **several years**			
c). If you come to know that the Islamic bank is not doing its business according to the principles of *Sharī'ah*			
d). If you come to know that a part of the income of the bank is from interest?			
e). If there are rumors about poor management of the bank?			
13. Which of the following do you think applies to the deposits:	**Amount guarantee d in full**	**Possibility to incur losses**	**Always earn a positive return**
a). Current Account			
b). Savings Account			
c). Investment Account			

“CORPORATE GOVERNANCE IN ISLAMIC FINANCIAL INSTITUTIONS”

Questionnaire for Depositors
(for Sudan)

Name of the bank: ________________ Date: __________________

Respondent’s Number:________Age:_______Education (Years): ________

Employment: Government employment ☐ Private sector employment ☐ Business ☐ Student ☐ Unemployed ☐ Others ☐

12. Do you have account in other banks?
    i. Yes ☐
    ii. No ☐

13. What kind of Account you have in this bank?
    i. Current Account ☐
    ii. Saving Account ☐
    iii. Investment Account ☐
    iv. Other ☐
    (Please specify) ____________________________________

14. How would you rank the services of the bank compared to other banks?
    i. Better ☐
    ii. Same ☐
    iii. Worse ☐

15. Do you look at the Annual Report of the bank to ascertain its performance?
    Yes ☐ No ☐

16. Do you think as investment depositors you should have a say in the management of the bank?
    Yes ☐ No ☐

    If Yes: It should be

i. Representation in the Board □
ii. Representation in the Annual General Meetings □
iii. Don't know □

17. Do you know the name of the CEO or President of the bank?
Yes □ No □

18. If some mutual funds provide similar features of investment account, would you transfer funds from your investment account to mutual funds?
Yes □ No □ Don't Know □

19. Are you provided with regular income statements indicating the rate of return on your deposits?
Yes □ No □

20. Can you get information on the rate of return on your deposits at any time from the bank if you wanted?
Yes □ No □

21. Do you know if the bank has a *Sharī'ah* Board?
Yes □ No □

Please mark the appropriate boxes with ✕.

11. What will you do, if:	**Keep your deposits with the bank**	**Shift deposits to another bank**
a). If the bank's rate of return is lower than other banks in **one year**		
b). If the bank's rate of return is lower than other banks for **several years**		
c). If you come to know that the Islamic bank is not doing its business according to the principles of *Sharī'ah*		
d). If you come to know that a part of the income of the bank is from		

interest?			
e). If there are rumors about poor management of the bank?			
12. Which of the following do you think applies to the following deposits:	**Amount guaranteed in full**	**Possibility to incur losses**	**Always earn a positive return**
a). Current Account			
b). Savings Account			
c). Investment Account			

APPENDIX 2

Code of Best Practices for Corporate Governance in Islamic Financial Institutions

Since corporate structures as well as the environment for governance vary widely from country to country, the principles of corporate governance cannot be a ‘one size fits all’ proposition. A number of factors, including the social mores, the political climate, the laws of the country, the regulatory and supervisory framework, and the accounting system determine the business and legal environment for corporate governance and need to be taken into account. Together they determine issues like protection of shareholder rights and enforceability of contracts that are exogenous to the financial institution. Hence, while good corporate governance is indispensable for all financial institutions, the principles related to it need to be applied in a flexible way to be in harmony with the varying environment and individual circumstances of financial institutions. This implies that good corporate governance is not just a matter of complying with a number of hard and fast rules. Thus, the codes and principles provided here should only be seen as guidelines for a framework to be built upon by different Islamic financial institutions and regulatory and supervisory authorities.

Within an Islamic financial institution, just as in a conventional one, the key players who can be directly held responsible for establishing sound corporate governance practices are the Board of Directors, the Management, the auditors, and the *Sharī‘ah* Board. The Board is responsible for the operations of the institution on behalf of the shareholders, depositors and other stakeholders. The *Sharī‘ah* Board is expected to assure that the operations of the Bank conform to the principles of Islam. The auditors must ensure the preparation of financial statements in compliance with international practices as well as the policies, rules, and regulations of the Bank. We give below the main elements of the codes of best practices for corporate governance with respect to these key players along with relevant operational issues and bodies.

1. The Board of Directors

1.1 Every Islamic financial institution should be headed by an effective board which should lead and control the institution. The directors are responsible to govern the bank and are the primary overseers of the institution.

1.2 The members of the board should represent and protect the long-term interests of the shareholders as well as all other concerned stakeholders, including depositors.

1.3 Board members should be qualified for their positions and have a clear understanding of their role in corporate governance.

1.4 There should be a formal and transparent procedure for the appointment of new directors to the board. One way to do so is to establish a nomination committee that follows a formal procedure of appointments (see 1.16d below).

1.5 All directors should be required to submit themselves for re-election at regular intervals and at least every three years.

1.6 The board should include a balance of executive directors and non-executive directors, and representatives from the *Sharī'ah* board so that no individual or small groups of individuals can dominate the board's decision taking.

1.7 Chairman of the board and Chief Executive Officer perform two distinct jobs in any organization. It is preferable to have two different individuals to hold these two positions. There should be a clearly accepted division of responsibilities at the top of the institution to ensure a balance of power and authority, such that no one individual has unfettered powers of decision. If these two positions happen to be held by a single person, it is essential that there should be a strong and independent element on the board, with a recognized senior member.

1.8 The board should be supplied with all relevant information in a timely fashion to enable it to discharge its duties.

1.9 The board should meet regularly, retain full and effective control over the company, and monitor the executive management.

1.10 The board should have a formal schedule of matters specifically reserved to it for decisions to ensure that the direction and control of the company is firmly in its hand.

1.11 There should be an agreed procedure, if necessary, to enable the directors to seek independent professional advice in the furtherance of their duties, at the company's expense.

1.12 All directors should have access to the advise and services of the company secretary, who is responsible to the board for ensuring that the board procedures are followed and that applicable rules and regulations are complied with. Any question of the removal of the secretary should be a matter for the board as a whole.

1.13 Every director of the board should keep abreast of his responsibilities as a director. Newly appointed board members should receive an appropriate briefing on the institution's affairs and be provided with relevant corporate governance materials by the secretary of the board.

1.14 A formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual executive directors. One option is to establish a remuneration committee which is responsible to the board (see 1.16c below).

1.15 A procedure for assessing the collective performance of the board and its individual members should be considered.

1.16 It may be beneficial to establish specialized committees including:

i) Risk Management Committee, to provide oversight of senior management's activities in managing different risks.

ii) Audit Committee, to review and supervise the company's financial reporting and to provide oversight of the institution's internal and external auditors and related issues (see 7.5 for more discussion).

iii) Compensation/Remuneration Committee, to ensure that the compensation policy is consistent with the institution's culture, objectives, and control environments and to provide oversight of the remuneration of senior management and other key personnel.

iv) Nominations Committee, to provide important assessment of the board's effectiveness and to be responsible for renewing and replacing board members.

2. Non-Executive Directors

2.1 For the board to be effective, at least one-third of the board members should be non-executive.

2.2 People from a wide range of backgrounds will be able to make a better contribution as non-executive directors.

2.3 The majority of non-executive directors should be independent.

2.4 Every non-executive director must ensure that he can give sufficient time and attention to the affairs of the institution and should not accept the appointment if he cannot.

2.5 Non-executive directors should bring an independent judgment to bear on issues of

strategy, performance, resources, including key appointments, and standards of conduct.

2.6 The majority of the non-executive directors should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgment, apart from their fees and shareholding. Their fees should reflect the time which they commit to the institution.

2.7 Non-executive directors should be appointed for specific terms and their reappointment should not be automatic.

2.8 Non-executive directors should be selected through a formal process and both this process and their appointment should be a matter for the board as a whole.

3. Executive Directors

3.1 Boards should appoint as executives directors only those executives whom they judge able to take a broad view of the institution's overall interests.

3.2 Directors' services contracts should not exceed three years without shareholder approval.

3.3 Levels of remuneration should be sufficient to attract and retain the directors needed to run the institution successfully. Separate figures should be given for salary and performance-related elements and the basis on which performance is measured should be explained.

3.4 Executive directors pay should be subject to the recommendations of a remuneration committee made up wholly or mainly of non-executive directors.

4. Senior Management

4.1 Senior management consists of a core group of officers responsible for the institution. These

individuals must have the necessary skills to manage the business under their supervision.

4.2 Senior managers should assume the oversight role with respect to line managers in specific business areas and activities as well as appropriate control over the key individuals in these areas.

4.3 Key management decisions should not be made by one person.

4.4 Senior management should not be overtly involved in business line decision-making.

5. Employees

5.1 All employees should have an understanding of the bank, its objectives, the markets in which it operates, and the risks its faces

5.2 All employees should have responsibility for internal control as part of their accountability for achieving the objectives.

5.3 The employees should have the necessary knowledge, skills, information and authority to establish operate and monitor the system of internal controls.

6. *Sharī'ah* Board

6.1 The *Sharī'ah* board should ensure that the current operations of the bank conform to *Sharī'ah* principles.

6.2 When a new product is launched by the institution, the *Sharī'ah* board should ensure its compatibility with *Sharī'ah.*

6.3 Reports and communications with respect to issues related to Islamic values and sensitivities should be monitored and supervised. These may include environmental issues, avoiding dealing in

certain products and services deemed objectionable, etc.

7. Auditors

7.1 The board should recognize and acknowledge that internal and external auditors are critical agents. The importance of audit process has to be communicated throughout the financial institution.

7.2 The board should utilize the work of auditors as an independent check on the information received from management on the operations and performance of the institution.

7.3 Measures should be taken to enhance the independence and stature of the (internal) auditors. The head auditor should, in particular, report to the board (or board's audit committee) directly to ensure his independence.

7.4 The findings of the auditors should be utilized in an effective and timely manner.

7.5 External auditors should be engaged to judge the effectiveness of internal controls.

7.6 The management should be required to make timely corrections of the problems identified by auditors.

8. Accountability and Controls

8.1 The board should present a balanced and understandable assessment of the institutions position and prospects.

8.2 All directors, executive and non-executive, should be entitled to have access to board papers and materials. Where queries are raised by non-executive directors, steps must be taken to respond as promptly and fully as possible.

8.3 The board should maintain a sound system of internal controls to safeguard shareholders' interests and assets of the institution.

8.4 The board should ensure that an objective, professional, and transparent relationship is maintained with the auditors.

8.5 The board should establish an audit committee of at least three non-executive directors with written terms of reference which deal clearly with its authority and duties. Among the committee's principal duties should be the review and supervision of the company's financial reporting and internal controls, appointment/dismissal and oversight of the institution's internal and external auditors, and receipt of all necessary information regarding compliance with policies, rules, and regulations in a timely manner.

8.6 The external auditors should independently report to the shareholders in accordance with statutory and financial requirements and independently assure the board of the discharge of its responsibilities.

9. Compensation Policies

9.1 The board can consider establishing a compensation/ remuneration committee that is responsible for setting up the compensation policy and provides oversight of remuneration of senior management and other key personnel.

9.2 The board of directors should approve compensation of the members of senior management and other key personnel and ensure that such compensation is consistent with the bank's culture, objectives, strategy, and control environment.

9.3 There should be a link between incentive compensations to the business strategy so as to discourage managers from booking business based upon volume and/or short-term profitability without regard to short- and long-term risk consequences.

9.4 In order to avoid incentives being created for excessive risk-taking, the salary scales should be set, within the scope of general business policy, in such a way that they do not overly depend on short-term performance.

10. Board Meetings

10.1 Full board meetings should be held no less frequently than every six months. "Full" board meetings means meetings at which directors are physically present (and not "paper" meetings or meetings by circulation.

10.2 Except in emergencies, adequate notice of a board meeting should be given to all directors to give them opportunity to attend the same.

10.3 Except in emergencies, an agenda and accompanying board papers should be sent in full to all directors at least 5 days before the intended date of a board meeting (or such other period as the board agrees).

10.4 Full minutes should be kept by a duly appointed secretary of the meeting and such minutes should be open for inspection at any time during office hours on reasonable notice by any director.

10.5 If, in respect to any matter discussed at a board meeting, the independent non-executive directors hold views contrary to those of the executive directors, the minutes should clearly reflect this.

10.6 If a matter to be considered by the board involves a conflict of interest for a substantial shareholder or a director, a full board meeting should be held and the matter should not be dealt with by circulation or by committee.

11. Annual Report, Information Disclosure, and Transparency

11.1 It is the directors' responsibility to prepare financial statements that fairly present the state of affairs of

the company at the end of the financial year and the profit or loss for that period.

11.2 The maintenance of adequate accounting records and adherence to applicable accounting standards should be reported.

11.3 In annual reports, institutions should include a narrative of how they apply the broad principles on corporate governance.

11.4 The maintenance of an effective system of internal controls should be disclosed.

11.5 There should be full and clear disclosure of the directors total emoluments and those of the chairman, including pension contributions and stock options, if any. The director's fees and any other reimbursement or emolument payable to an independent non-executive director should be disclosed in full in the annual report and accounts of the institution.

11.6 The terms of appointment of the non-executive directors should be disclosed in the annual report and accounts of the institution. The board should also disclose which of the non-executive directors are considered independent.

11.7 The directors should explain their responsibility for preparing the accounts next to a statement by the auditors about their reporting responsibilities.

11.8 Reports and communications with respect to other stakeholders should also be made to ensure transparency and accountability. These should include issues with respect to Islamic principles as well as employment policies, environmental issues, and issues having Islamic sensitivity.

11.9 Public disclosure is desirable in the following areas:

i) Board structure (size, membership, qualifications and committees).

ii) Senior Management structure (responsibilities, reporting lines, qualifications and experience).

iii) Basic organizational structure (line of business structure, legal entity structure).

iv) Information about the incentive structure of the institution (remuneration policies, executive compensation, bonuses, etc.).

v) Nature and extent of transactions with affiliates and related parties (like individuals and subsidiaries that have influence over the institution).

12. Code of Ethics

12.1 The institution should adopt and implement its Code of Ethics as part of corporate governance of the corporation.

12.2 The code of ethics should be developed in such a way that it involves all the bank's stakeholders with a view to infuse in them, among others, Islamic ethics and culture.

12.3 The code of ethics should commit all involved with the institution to the highest standards of behavior

12.4 The code of ethics should receive total commitment from the board and chief executive officer of the institution.

12.5 The code of ethics should be sufficiently detailed as to give a clear guide to the behaviour expected of all employees.

GLOSSARY OF ARABIC TERMS USED FREQUENTLY

Some of these terms have a much wider meaning. It is, however, not possible to encompass this in a glossary. Given below is the basic sense in which these terms are generally used.

Fiqh :	Refers to the whole corpus of Islamic jurisprudence. In contrast with conventional law, *fiqh* covers all aspects of life, religious, political, social or economic. In addition to religious observances like prayer, fasting, *zakāt* and pilgrimage, it also covers family law, inheritance, social and economic rights and obligations, commercial law, criminal law, constitutional law and international relations, including war. The whole corpus of *fiqh* is based primarily on interpretations of the Qur'an and the *Sunnah* and secondarily on *ijmā‘* (consensus) and *ijtihād* (individual judgement). While the Qur'an and the *Sunnah* are immutable, *fiqhi* verdicts may change due to changing circumstances.
Fuqahā' : *(singular, faqīh)*	Jurists who give opinion on various juristic issues in the light of the Qur'an and the *Sunnah* and who have thereby led to the development of *fiqh.*
Ḥadīth : *(plural, aḥādith)*	A report on the saying, deed or tacit approval of the Prophet, peace and blessings of God be on him.
Ijārah,	Leasing.
Isti ´'`nā‘ :	Refers to a contract whereby a manufacturer (contractor) agrees to produce (build) and deliver a certain good (or premise) at a given price on a given date in the future. This is an exception to the general *Shari‘ah* ruling which does not allow a person to sell what he does not own and possess. As against s*alam* (q.v.), the price here need not be paid in advance. It may be paid in installments in step with the preferences of the parties or partly at the front end and the balance later on as agreed.

Maqāsid al-Sharī'ah		Goals of the *Sharī'ah.*
Muḍārabah	:	An agreement between two or more persons whereby one or more of them provide finance, while the others provide entrepreneurship and management to carry on any business venture whether trade, industry or service, with the objective of earning profits. The profit is shared by them in an agreed proportion. The loss is borne only by the financiers in proportion to their share in total capital. The entrepreneur's loss lies in not getting any reward for his/her services.
Murābaḥah	:	Sale at a specified profit margin. The term is, however, now used to refer to a sale agreement whereby the seller purchases the goods desired by the buyer and sells them at an agreed marked-up price, the payment being settled within an agreed time frame, either in installments or lump sum. The seller bears the risk for the goods until they have been delivered to the buyer. *Murābaḥah* is also referred to as *bay' mu'ajjal.*
Mushārakah	:	An Islamic financing technique whereby all the partners share in equity as well as management. The profits can be distributed among them in accordance with agreed ratios. However, losses must be shared according to the share in equity.
Qur'ān	:	The Holly Book of the Muslims, consisting of the revelations made by God to Prophet Muhammad, peace and blessings of God be on him, during his Prophethood of about 23 years. The Qur'an lays down the fundamentals of the Islamic faith, including beliefs and all aspects of the Islamic way of life.

Salam	:	Sale in which payment is made in advance by the buyer and the delivery of goods is deferred by the seller. This is also, like *Istisnā‘,* an exception to the general *Sharī‘ah* ruling that you cannot sell what you do not own and possess.
sarraf	:	During the Classical Islamic period, the term stood for a banker who performed most of the functions of a modern bank within the prevailing technological environment. The equivalent modern term is *ma ´´‛raf* and the term *´´‛arrāf* is now used for a money charger.
Sharī ‘ah	:	Refers to the divine guidance provided in the Qur’an and the *Sunnah* and embodies all aspects of the Islamic faith, including beliefs and practices.
Sunnah	:	The *Sunnah* is the most important source of the Islamic faith after the Qur’an and refers essentially to the Prophet’s example as indicated by his practice of the faith. The only way to know the *Sunnah* is through the collection of *a[illegible]ādīth*, which consist of reports about the sayings, deeds and reactions of the Prophet, peace and blessings of God be on him (see also *[illegible]adīth).*

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